HOLDERS OF RAILROAD BONDS AND NOTES

THEIR RIGHTS AND REMEDIES

LOUIS HEFT

HOLDERS OF RAILROAD BONDS AND NOTES: THEIR RIGHTS AND REMEDIES

Treating Particularly of the Receivership and of the Reorganization of the Road, of the Foreclosure of the Mortgage and of the other Proceedings to Realize on the Security.

BY

LOUIS HEFT

OF THE NEW YORK BAR

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TO
THE MEMORY OF
MY FATHER

PREFACE

It is fairly safe to say that the great majority of the holders of railroad bonds and notes never read their securities nor the mortgage that secures them. It is only when the railroad company, whose securities they hold, becomes insolvent or defaults that they seek advice as to their rights. Then, quite generally, for the first time, they ask for a better understanding of the nature of their securities; of their rights as to the other creditors and the property of the road; of their probable relations with their trustee, the receiver, and the reorganization committee. The foreclosure and the receivership, that usually follow the insolvency of a railroad company, and the reorganization of the road, that is invariably attempted, present many situations that affect its security-holders, of which they should have at least a fair understanding.

Recent governmental investigations have pointed clearly to the extreme ignorance of the investing public as to their rights as holders of corporation securities. It is hoped that the information contained in these pages may help to a better understanding of the nature of railroad securities and of

the rights and remedies they confer on their holders, and that such knowledge may help to safeguard investments.

L. H.

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HOLDERS OF RAILROAD BONDS AND NOTES: THEIR RIGHTS AND REMEDIES

CHAPTER I

INTRODUCTORY

Three values of a railroad security.

Generally speaking, a railroad security may be said to have three values. It has a market value, the price at which it can be bought and sold (probably) in the market. It has an intrinsic value, depending upon the solvency of the issuing company and the property or security behind it. It has a legal value, founded upon the rights and remedies its ownership confers to enforce its payment and which entitles it by reason of its legal lien or standing to be paid out of certain property of the road or out of all its property, as the case may be, before other creditors or other classes of creditors receive anything.

Market value.

The market value of a railroad security does not depend always upon its actual, intrinsic value alone,

i. e., upon the property and its foreclosure value, pledged as security, and the other liens, prior and junior, against such property; but it is affected, quite often, and sometimes quite materially, by extraneous influences, among them the temper of the times; the state of the money market; the quoted price; whether or not it has a broad and ready market and is a legal investment for trust funds or savings banks; its form, whether easy of negotiation and how quickly it can be converted into cash; when it matures; its rate of interest and the income it produces at the price; whether or not it is listed on the stock exchanges; the personnel of the board of directors of the railroad company; the prevalent reports, true or false, of the state of the finances and affairs of the road; the effect of recent legislation or expected legislation; recent decisions of the higher courts; pending litigation that affects the road; events and reports of political significance, local, state, national or international.

Intrinsic value.

To determine the intrinsic value of a railroad security, inquiry is directed by experts to the credit and standing of the issuing company; the condition of its finances; the nature of its franchises; the property mortgaged as security and its physical condition; what the prior and later liens against this property are; the company's entire property generally; the contracts and leases by which the road is bound or has

the advantage of; what the entire outstanding bonded indebtedness of the company is and how it is secured; whether the bonded indebtedness of the issuing company is in excess of the actual or foreclosure value of the road as near as it can be judged; whether the proportion of the bonded indebtedness to the capital stock of the road is proper; the topography of the country over which the road is laid; the geographical position of the road and whether it commands a strategic position; whether it serves a needed purpose; its future prospects; whether the territory and termini served can be reasonably expected to maintain the road; whether the population in the territory and points served is increasing or decreasing; the character of the traffic, whether it is limited to certain industries or is general and diversified; what rival lines are in competition; whether the road is likely to be absorbed by a larger one and the possibility of its securities being made valueless upon the market before the absorption; the personal character and efficiency of the company's management; its policies; its aggressiveness or conservativeness; whether or not the business of the road is being conducted along conservative lines; whether or not those in control have other interests that conflict with the best interests of the company; the amount of business the road is doing; its permanent earning power; the proportion that the capitalization of the road per mile bears to the earning capacity per mile; whether the

gross earnings have been maintained from year to year; whether the ratio of the operating expenses per mile is reasonably proportioned to the gross earnings per mile and that this proportion has been maintained from year to year; that the fixed charges are for proper purposes and are kept to the minimum and are not out of proportion to the gross earnings; and in addition such other matters as the particular issue under consideration calls for.

The average investor has neither the opportunity to get at these facts nor the experience in the various branches of expert knowledge necessary to understand or judge them. These matters should be and are examined into by financial and engineering experts upon whose opinion the bankers depend when underwriting or purchasing an issue, and it is upon the recommendations of the latter as to the intrinsic value of the security that the intending investor usually and necessarily relies.

Legal value.

The legal value of a railroad security is the foundation of both its market and intrinsic values. For its legal rank as a security, its rights to priority in payment over the other indebtednesses of the company, its form and negotiability, and such special rights and privileges that may be peculiar to that issue, affect its market value and enter materially into a consideration of its intrinsic value.

While the railroad company is paying interest regularly and there is no apparent reason for concern, the legal rights and remedies that the security may carry with it are not given much thought. Then the price at which it may be bought or sold and the ready market that it may have are alone considered. But when the railroad company falls into insolvency then the safety of the security is thought of. And in the usual struggle among its creditors over its assets, those rights that enable the holders of its securities to obtain payment in full in preference to or priority over other creditors or other classes of creditors become of prime importance. It is this that constitutes the legal value of a railroad security and upon which its market and intrinsic values depend.

In adjusting the affairs of an insolvent railroad corporation, the court usually finds itself confronted with claims of many kinds and with many classes of creditors. In the unraveling of the entangled mesh each strand must be given its position.

Usually it will be found that the insolvent road is a system consisting of a number of branch lines operated under leases or by subsidiary companies. These subsidiary companies are invariably controlled by the main or parent company by means of a controlling interest in their capital stocks or by ownership of their properties. The financing of these extensions, branch, subsidiary, divisional and leased lines, and of the main or parent road, results in many

issues of notes and bonds and other forms and kinds of securities. And it is not unusual that the insolvency of a railroad will find creditors holding bonds secured by underlying liens against all or certain portions of the property of the road issued by constituent companies before consolidation or representing the original mortgages upon the road, followed by first, second, general, blanket or unified mortgages on the entire system; collateral trust bonds issued by the parent company and secured by a deposit of the stocks and bonds from its own treasury or the securities of its subsidiary companies; also bonds resulting from an attempt at readjustment or reorganization, such as extended bonds, prior lien bonds, adjustment bonds, income bonds, etc.; outstanding notes or debentures that are not secured; car trust certificates or equipment bonds may cover the rolling stock and equipment of the road; terminals may have been mortgaged to secure an issue of bonds or notes; some of the creditors may have outstanding attachments against the road, or may have reduced their claims to judgments; interest on preferred stock may have been made a lien on the property of the road or some parts of it; certain claims for labor and materials may be entitled to preference as operating expenses or under statutes; claims for injuries to persons or property caused in the operation of the road before the receivership may be given a preference by the statutes of some of the States; mechanics' liens

may be charged against the property of the road. And, further, should a receiver be appointed he may, under order of the court, issue receiver's certificates, which may be given a lien prior to and a preference over mortgages and other liens then against the property of the road. Also the claims for the expenses of the receivership and of the operation of the road by him, and the expenses of the trusteeship, and the costs and expenses of the litigation are given a priority in payment over all the preceding claims. And the debts for taxes and other governmental charges are usually entitled to a preference over all others.

The relative rights and standings of these different securities and claims, their priorities and preferences, and the order in which each shares in the assets of the railroad company, constitute their legal values, and it is the purpose of these pages to discuss and to analyze each security or claim against the road that will in any way affect the rights or the remedies of the holders of the outstanding bonds and notes, and show the reason for the standing, priority or preference accorded it.

CHAPTER II

RIGHTS AND REMEDIES WITH RELATION TO THE VARIOUS KINDS OF RAILROAD BONDS AND NOTES

General description of railroad bonds, notes, and debentures; bonds and notes compared; power of railroad company to issue same; temporary bonds.

A bond of a railroad company may be described, generally, as its written obligation to pay a certain sum of money, on a specific date, with interest at a fixed rate, the interest payable at stated periods.

Speaking broadly, a railroad bond resembles, in its nature, the usual promissory note. The bond is more elaborate in form, and more formal in its execution; and usually in addition to the elements that make up a promissory note, the bond contains terms that confer on its holder, or registered owner, certain special rights and remedies, and reserve in the railroad company making the issue certain special privileges. What these special rights, remedies, and privileges are depend upon the kind of bond in question, to which discussion will be directed later.

A railroad company, when it is necessary for proper corporate purposes, may borrow money and

issue bonds as evidences of such indebtedness and of its promise to pay.

It is quite commonly the law in most of the States that before a railroad company may issue its bonds or stocks, it must first obtain from the public service commission having control of the jurisdiction to which the railroad company is subject, an order authorizing such issue and the amount thereof and stating that, in the opinion of such commission, the use of the capital to be secured by the issue of such stock or bonds is reasonably required for the corporate purposes of the railroad company.

When a railroad company issues and sells its bonds, it is in effect selling its written promise to pay the money it then borrows. Each issue is a promise to pay the entire amount authorized; and each bond of that issue represents that entire promise divided into as many parts as there are bonds.

A railroad company has power to issue bonds for any purpose for which it might lawfully contract a debt. This power to issue bonds is regarded as incidental to the inherent powers of the corporation and need not be expressly conferred on it by its charter or any statute. But the exercise of this power to issue bonds may be limited, restricted or regulated by some provision in the charter of the corporation, or a statute, or the constitution of the State in which the railroad company is incorporated. Bonds issued in violation of these limitations, restrictions or regula-

tions are, as a rule, void. Fairly typical of such provisions is that which declares that the aggregate amount for which a railroad company may issue and have bonds outstanding, shall not exceed a specified proportion of its capital stock or property.

Unless restrained by law, a railroad company may use any form of security that any other corporation or individual might under the same circumstances.

Railroad bonds are usually made payable at far distant dates, so that the money raised by them and employed in the building, equipping and improving of railroads may have a full opportunity to bring forth its fruit. When the rate of interest and the market conditions are favorable, the bonds are for long terms; and, conversely, when the rate of interest is high and the market is unfavorable, the issuing company will put out *notes* for a short term, and when conditions become more satisfactory, long term *bonds* are issued and the short term *notes* are taken up.

An issue of railroad notes, like an issue of railroad bonds, is the written promise to pay a certain sum of money at a specified date, with a fixed rate of interest. Railroad notes differ from railroad bonds only, usually, in the particular pointed out, that they are for shorter periods. Railroad notes may be issued in coupon form, as bonds may be, and have coupons attached to represent the interest.

Railroad notes are sometimes secured by a mort-

gage on the property of the road, or by a deposit of collateral securities, or in any other way that railroad bonds are secured.

The same rules of law apply to notes as apply to bonds and the same situation is presented when notes are issued or secured as when bonds are. And throughout these pages where reference is made to bondholders it is intended to have reference to noteholders also, where the issue is of notes and where the circumstances are alike except that the instrument is a note instead of a bond.

When a railroad bond is not secured, it is quite generally known as a "debenture." To prevent the railroad company, by subsequently mortgaging its property, from practically disposing of its assets, it is usually provided in the agreement pursuant to which the debentures are issued that the railroad company shall not place any mortgage upon its property; in this way while the debentures are not secured, they are protected in that the equity in the property as it existed at the time of the issue and to which they looked for payment will not be taken from them by mortgages to secure later issues of bonds or other forms of indebtedness. Or provision may be made to the effect that should the railroad company place any later mortgage upon its property that such debentures shall be included in such later mortgage and be secured by it.[1]

[1] The term "debenture" is used in the English speaking nations

Until the bonds can be engraved, the railroad company usually executes and delivers temporary bonds, which are either printed or lithographed, and are substantially of the tenor of the engraved or permanent bonds. Each temporary bond bears upon its face the statement that it is a temporary bond and is exchangeable for a like principal amount of engraved bonds. Temporary bonds must be authenticated by the trustee's certificate in the same manner as the permanent or engraved bonds. When the temporary bond is exchanged for the engraved bond, it is cancelled by the trustee; and until so exchanged, the temporary bond confers on its holder all the rights that the engraved bond does.

to designate instruments widely different in their characteristics. In the financial circles of the United States, it is used to convey the idea of an unsecured bond. It is also applied here to certificates given by the collector of the ports of entry for moneys due by the United States Government to importers for drawback of duties on merchandise. In some of the governmental departments, the term is employed to designate bonds or bills by which the government is charged to pay money due on the auditing of accounts.

The term "debenture" is used throughout Great Britain and her colonies to designate the bond obligations of municipalities.

In England the term is used to designate the bonds of municipal and other corporations; and it also is the name applied to custom house, exchequer, and other governmental obligations. It is chiefly employed there to designate an instrument issued by a corporation which creates or acknowledges a debt and usually, though not necessarily, charges the property and undertaking of the issuing company.

In Canada while the obligations of municipalities are also referred to as debentures, they are more particularly designated "municipal debentures." It seems to be the custom there to refer to bonds of municipalities as "municipal debentures" and the bonds of other corporations as "bonds."

It is invariably provided in railroad mortgages that the bonds under it shall be signed by such persons as shall, at the time of such signing, be the president or the vice-president of the issuing company, and that the corporate seal of the company shall be affixed and that it shall be attested by such person as shall, at such time, be the secretary or an assistant secretary; and that the coupons shall be authenticated by the engraved signature of the present treasurer, or of any future treasurer, of the issuing company. And, it is invariably further provided that, should any of such bonds have been signed and sealed by the officers of the issuing railroad company, and thereafter such persons shall cease to be such officers, such bonds may be delivered to the trustee to be certified to and put out by him, or returned to the railroad company to be put out by it, as the case may be, with the same effect as if such persons had not ceased to be such officers of the issuing railroad company.

Transfer of bonds.

The bond may be payable to bearer or to the order of a designated payee.

When payable to bearer, the bond is transferred by its delivery from hand to hand, without any writing. When payable to the order of a designated payee, the bond must be transferred in writing.

When the bond is issued with the space reserved

for the name of the payee left blank, any holder has the legal right to fill in his own name as payee. While the holder has the legal right to do this, the filling in of his name as payee in the blank space may affect its commercial value. It is then a "marked bond," the expression used in financial circles, and no longer accepted as a "good delivery."

With the space for the name of the payee left blank, the bond is regarded as payable to bearer and transferred by its mere manual delivery; when the name of the holder has been filled in the space reserved, the bond becomes payable to his order and is then transferrable only by his written assignment.

A registered bond is one that bears the name of its payee on its face, and is registered in the name of such payee on the books of the railroad company, or the fiscal agency designated for that purpose. It is transferred by written assignment or power, in a form approved by the railroad company. Some bonds have the form printed on their backs. The bond and assignment are delivered to the new owner, who then presents them to the railroad company or the fiscal agency, as the case may be, and the name of such new owner is then registered on the books of the company and a notation made on the bond signifying its registration, or a new bond may be issued with the name of the new owner on its face as payee. See *Registered bonds; act of registration, etc.* Page 48. See also *Transfer of registered bonds, etc.* Page 50.

Difference between bondholders and stockholders.

As the bond is the written promise of the railroad company to pay to the one entitled thereto, according to its terms, the holder of such bond is a creditor of the issuing railroad company.

The bondholders are creditors of the railroad company; the stockholders are members of the company that owes the money to the bondholders. The bondholders are entitled to demand payment of their bonds and interest of the railroad company; the stockholders are members of the company that must pay the bondholders.

When the assets of a railroad company are finally distributed upon a winding up of its affairs, the bondholders and the other creditors are first paid in full, according to their respective priorities, before the stockholders receive anything. Stockholders are entitled to their shares of the assets of the corporation only after all the creditors, of every kind, have been paid in full.

Bondholders, like other creditors, ordinarily, do not have the power to vote at any of the corporate meetings. Stockholders do have this right. In some instances, though rarely, the power to vote is given to bondholders, either by the terms of the mortgage or by the statute laws of the State.

The bondholders receive a fixed rate of interest on their bonds, which is a fixed charge or expense of the railroad company; the stockholders (of common

stock) receive dividends on their stock dependent upon the condition of affairs of the company and as the board of directors shall declare them. The holder of the preferred stock is paid his stipulated rate of dividend only after the interest on the bonded indebtedness and all the annual fixed charges are paid. He is in the same position with relation to the bondholder as is the holder of the common stock, though his dividend is payable before that of the latter and sometimes his interest in the assets of the corporation has priority over that of the holder of common stock.

Bondholders are bound by the terms of the bond and mortgage; the contract between the parties.

The bondholder is bound by all the terms and provisions and conditions contained in his bond. He is chargeable with notice of all the facts that appear on its face or are endorsed on it. He is chargeable also with notice of all the terms, conditions, and provisions contained in the mortgage when the bond refers to the mortgage with sufficient directness to apprise him of its existence. The provisions of the mortgage, by such reference, become part of the bond with the same effect as if there set forth at length.

The bond and the mortgage constitute the contract between the bondholder, the railroad company, and

the trustee. And like all contracts its provisions are binding on all the parties to it. It is in the construction that the courts put on the language used in these two documents, that the rights and remedies of the bondholders are to be found. The courts, in construing the language of the bond and the mortgage, are controlled by statute laws, the general precedents, and by the principles that apply particularly to railroad property and which govern the peculiar relations that exist between the bondholders and the trustee and the railroad company; all of which is read into and form part of the bond and mortgage. These statute laws, general precedents, and particular principles will be presented and discussed, throughout these pages, under the appropriate headings.

The legal residence of a railroad company is the State under the laws of which it is created; and it is the law of that State that governs the construction of the contract of the parties.

Each bondholder is bound by the terms of this contract; and each is entitled to its protection. And neither the trustee, nor any reorganization committee, nor any majority of the bondholders, can deprive him of any of his rights by making any change in the terms of the bond or the mortgage, or by waiving any default by the railroad company under them, unless the bondholder has agreed and consented that they have such power. This power to

bind all the bondholders of an issue by the acts of a majority or of the trustee, may be conferred by the terms of the mortgage, or by the statute law of the State which, as was seen, forms part of the bond and the mortgage.

In case of a conflict between the terms of the bond and the mortgage, those of the bond will prevail; for the bond is the written evidence of the indebtedness, while the mortgage is the instrument merely that insures the payment of such indebtedness. The bond is the basic document: the mortgage depends on the bond for existence. There may be a bond without a mortgage; there cannot be a mortgage without a bond.

Validity of bonds; over-issue; defective issue; issue in excess or abuse of power; issue in violation of law, or without power; secured by void mortgage.

Bonds issued by a railroad company in violation of its charter, or the constitution of the State, or some of its statute laws, or issued without any power, are void.

Railroad bonds that are valid in the State in which the railroad company that issued them is incorporated, are valid everywhere. Where a road runs through two or more States, it must be incorporated under the laws of each. And should the bonds be valid under the laws of any of these States they are

valid everywhere, even though they might have been invalid if issued under the laws of one or more of the other States in which the road is incorporated.

Bonds that are part of an over-issue or which have been defectively issued or which have been issued in excess or abuse of power where some power existed, are good in the hands of a bona fide holder, who has paid their reasonable value for them, purchased them in good faith before maturity, in the regular course of business, and without knowledge or notice of anything wrong. Should the holder of such bonds not meet all the requirements of bona fide holdership, as just detailed, then such bonds are void in his hands. Over-issued or defectively issued bonds, or bonds issued in excess or in abuse of power where the railroad company had some power to make the issue, are good only in the hands of a bona fide holder.

But a distinction is drawn between bonds that are over-issued, or issued defectively, or in excess or in abuse of a power that it possessed, and those issued in violation of law or without any power at all to do so.

Bonds issued in violation of law or without any power are void in the hands of all holders, including bona fide holders. There is, in these latter cases, no mere error or abuse of power that the law will seek to cure when such bonds have come into the hands of innocent bona fide holders; but here is a violation of the law that the court cannot condone,

and an absolute absence of power that the court cannot supply. However, where the railroad company has issued bonds without any power to do so, and it has actually received the money for them, the law will not permit it to benefit by its own wrong, and will then enforce payment of such bonds when held by bona fide holders. That is, notwithstanding that the railroad company had no power to issue the bonds in question, if it actually did, and received the money therefor, and they pass into the possession of holders who bought such bonds in good faith, before maturity in the regular course of business, and paid for them their reasonable value, and without knowledge or notice that anything was wrong, then the company must pay such bonds to holders answering all these requirements.

Bonds otherwise good are not affected by the fact that they are secured by a mortgage that is void or defective. Should the mortgage be void, for any reason, the security only fails and the bonds continue as theretofore. The bonds are good; the attempt to secure them has failed.

Many kinds of railroad bonds; classified generally as to form, security, purpose of issue, and mode of retirement, satisfaction, or exchange; distinctions pointed out.

There are many kinds of railroad bonds. The mortgages, too, that secure them vary in their terms.

It is doubtful if any two issues are exactly alike. However, they fall quite generally into classes that are basicly similar, differing only with respect to some special agreement or stipulation.

The names used to designate issues of railroad bonds suggest, in a general way, these special agreements or stipulations that characterize an issue.

In attempting to classify railroad bonds, they may be divided into those *relating to their form*, such as coupon bonds, registered bonds, with the privilege of converting or interchanging them; *those relating to their security*, such as mortgage bonds of the various ranks, as first, second, etc., general or blanket, prior lien, consolidated, terminal, income, collateral trust, and those, too, that are not secured such as, generally, notes and debentures; *those relating to the purpose for which they were issued*, as refunding, improvement, development, construction, etc., and *those relating to the mode of satisfaction*, *retirement*, *or exchange*, such as redeemable, callable, refunding, those with the privilege of converting into the capital stock of the issuing company, those calling for payment in gold, those with arrangement for sinking fund or serial payment.

Most railroad bonds contain one or more, if not all, of these features that are not inconsistent, such as a *first mortgage* (the security), *refunding* (the purpose), *gold* (the mode of payment), *convertible coupon* (the form) *bonds.*

The rights and remedies of a holder of a bond containing one or more of the different features discussed (form, security, purpose of issue, and mode of satisfaction, payment or retirement), are a combination of all the rights and remedies that each confers.[1]

If these names are accurately used, they will give in a general way an idea of the standing and of the nature of the security; but one should not depend on the name alone, as without any intention to deceive, the name "first mortgage," for instance, may be used, which, while giving the intending bondholder the impression that it is entirely a "first" mortgage, may be a first mortgage only upon a small portion of the property pledged as security, and an inferior lien upon the balance. Again, the term "first" may be used to designate it as the first of its kind that has been issued, without regard to the nature of the security, such as "first consolidated" mortgage bonds, which may be secured by a first mortgage upon the entire mortgaged property, so far as the consolidated company that issued that mortgage is concerned, but which is a mortgage subject, secondary, junior and inferior, to all the mortgages and other liens that attached to the property before the consolidation took place. See *Bonds*

[1] The right to priority in payment in the distribution of the assets of the insolvent road under each of the many forms and kinds of railroad securities are discussed in Chapter VII. *Rights and Remedies with Relation to the Assets of the Insolvent Railroad Company; Rights of the Other Creditors.*

or notes of consolidated roads; of the constituent roads. Page 286. *Underlying liens.* Page 271.

Rights of bona fide holders of negotiable bonds.

In the broad sense of the term, and as commercially understood, a railroad bond is negotiable when it is in such form that it may be transferred from hand to hand by delivery or assignment in blank. But a bond may be negotiable in that respect and may not be negotiable in the strict legal sense that it is here employed.

The purpose for discussing this phase of the form of railroad bonds, is that when a bond that is negotiable in the strict legal meaning of that term is held by a bona fide holder, the law grants such bona fide holder of such an instrument certain immunities and rights not ordinarily enjoyed by the holders of securities generally.

When a railroad bond, in the form of a negotiable instrument in the strict legal sense just mentioned, is held by a bona fide holder, no defense can be set up against him, when trying to recover on it, that grew out of any of the transactions that any of the previous holders may have had between them, or with the railroad company; nor can any defense then be set up that will defeat or diminish his claim, except such as deny the very existence and life of the instrument itself. Of these latter defenses forgery and lack of delivery of the instrument, are typical; as

where the trustee's certificate has been forged or not delivered. But no collateral understandings, or agreements, or violations of any contract, that previous holders may have had between them or with the railroad company, concerning such negotiable bond, can affect a bona fide holder.

As a general rule, bona fide holders are not affected by the misconduct of the officers of the railroad company in the management of its affairs, or by fraud in the issue or the negotiation of the bonds, unless they were parties to it.

If the bond be not in the form of a negotiable instrument, as here meant, each successive holder merely succeeds to the rights and liabilities of his predecessors in ownership, and in this way whatever claims might have been set up against any holder or owner in the chain of ownership may be set up against such present holder or owner.

In what form must a railroad bond be in order to be a negotiable instrument in the legal sense under discussion? The usual railroad bond is in that form because it contains the promise of the railroad company to pay a certain sum of money, at a certain time, to bearer (or to the order of a named payee and assigned in blank), free from conditions of any kind. The elements necessary to constitute a bond a negotiable instrument, therefore, and *all* of which *must concur* are: an unconditional promise to pay a definite sum of money, at a definite time, to bearer (or

to the order of a named payee and assigned by him in blank). There must be no uncertainty as to the amount to be paid, nor as to the time when it shall be paid; the promise to pay must be without any conditions and must not be dependent upon the happening of any event; and the bond must be payable to bearer or to the order of a named payee and assigned in blank by the latter.

By assignment in blank is meant that the name of the person to whom the assignment is made is not mentioned but the space reserved therefor is left blank so that he may pass it on from hand to hand without further writing of any kind.

Experience has shown that "dry-as-dust" information can be assimilated only by iteration and reiteration; therefore, at the risk of wearying the reader, in view of its importance, the elements necessary to make the bond a negotiable instrument are again repeated: the bond must contain an unconditional promise to pay a definite sum of money, at a definite time, to bearer (or to the order of a named payee and assigned in blank by him). There must be neither conditions nor uncertainty attached to the promise to pay, nor to the time of payment, nor to the amount.

Where the name of the payee is left blank, the law regards it as payable to bearer.

That the bond is numbered does not affect its negotiability; nor does the provision therein contained that it may be redeemed or called in, or paid off, in

any way, before maturity. And neither does an option to convert the bond into the capital stock of the issuing company; nor does a recital in the bond, "that it may be registered or made payable only on the books of the company," interfere with its negotiability.

The interests of the business world call for the aid of some medium for the exchange of its values, and negotiable railroad bonds meet in many ways this requirement. The law, therefore, gives them, so far as it can, the quality of negotiability so that, while not money, they may pass as the representatives of money. A negotiable railroad bond does circulate in many transactions upon the same basis as money. The law accordingly cloaks a bona fide holder of a negotiable bond with the protection which shields him, as was just described, so that he may accept and use his bond as if it were money itself. This is an exception to the general rule of law. The necessities of modern commerce have created it.

However, the principle is not carried beyond the business interests that created it. And the negotiability of the bond and the bona fide holdership must both be present, and all the elements that constitute each must exist. Therefore, the bond must contain an unconditional promise to pay a definite sum of money, at a definite time, to bearer (or to the order of a named payee and assigned in blank by him); and the person claiming the rights of a bona fide

holder must have purchased such bond, not directly from the railroad company, but in the open market in the regular course of business, in good faith, before its maturity, without notice or knowledge that there was anything wrong with it or of the defenses sought to be set up against him, and he must have paid therefor its fair and reasonable value. All the elements constituting the bond a negotiable instrument, in the sense here used, and all the elements constituting bona fide holdership must be present; should any be lacking, notwithstanding the presence of all the others, the case does not fall within the principles discussed.

A purchaser in the open market is not bound to make a close and critical examination of a bond to avoid the charge of bad faith.

One purchasing a bond in the regular course of business is not bound to make inquiries as to the rights to sell nor of the title of the one offering it for sale, nor to take any special precautionary measures to ascertain what hostile claims may exist to defeat it. But a deliberate avoidance of knowledge or wilful closing of the eyes to facts, when circumstances exist that are likely to arouse suspicion in the mind of a reasonably prudent man, will be construed to have the same effect as if such person actually had the knowledge that he so deliberately avoids.

To be a bona fide holder one need not have paid the par value of the bond. He need only pay the

reasonable value of the bond. If he paid much less than its value, it is a fact that bears on the question of good faith.

A bona fide holder is entitled to recover the face value of his bond no matter what he paid for it.

Lost or stolen coupon bonds or notes, or coupons.

If a bond negotiable in form, as just described, be lost or stolen, and the finder or thief sell it to one who is a bona fide holder, as previously discussed, such purchaser takes a good title to it and is entitled to the payment of his bond and its interest as against every one.

The bond, however, must be negotiable in form, that is, it must be a promise to pay a definite sum of money, at a specified date, free from conditions of any kind, to bearer or to the order of a named payee and assigned in blank. And the purchaser must be a bona fide holder, that is, he must have purchased his bond before its maturity, in good faith, in the usual course of business, that is, in the open market, and paid therefor its fair and reasonable value, without any knowledge or notice that there was anything wrong. But the negotiability of the bond and the bona fides of the holder must concur.

Should any of the elements of negotiability be missing, then the purchaser from the finder or thief does not get a good title to it, notwithstanding that all the elements of bona fide holdership are present.

And, notwithstanding that the bond contains all the elements necessary to make it a negotiable instrument, its purchaser from the finder or thief does not get a good title should there be lacking any of the elements necessary to constitute him a bona fide holder.

The railroad company does not pay to more than one party, of course. The loss falls on the one who lost the bond or from whom it was stolen. The bona fide purchaser from a thief or a finder of a stolen or lost negotiable bond gets a good title to it and is entitled to payment of all that is due on it, and all subsequent holders have the same rights.

Payment may be refused until the one demanding it shows that he is a bona fide holder and that the bond is negotiable in form. He is entitled to its face value, notwithstanding what he paid; however, should he have paid much less than its actual value it will have a material bearing on his bona fides.

In a proper case, the payment of the lost or stolen bond may be enforced by the party who lost it or from whom it was stolen; and a court of equity, it seems, will compel the execution of a duplicate bond in its place, upon the party applying therefor furnishing proper and sufficient indemnity to the railroad company to reimburse it should it be called upon to pay to a bona fide holder.

The rules that have been stated here with reference to lost or stolen bonds apply also to lost or

stolen notes or detached coupons. When coupons are still attached to a bond or note they are incidents of the same and are affected by whatever affects such bond or note.

Altered or mutilated bonds, notes or coupons.

An intentional changing, alteration, or mutilation of a railroad bond in any of its material parts makes it void when made by its holder or owner or by another at his instigation or with his consent.

If such alteration or mutilation be unintentionally made, though in a material part, it will not affect the bond; nor is a bond affected by an alteration or a mutilation by a stranger to it, though in a material part, when made neither at the instigation nor with the consent of its owner or holder.

An alteration in an immaterial part does not affect the bond no matter by whom made, nor under what circumstances.

Should a bond, note or a detached coupon become mutilated, the owner may notify the railroad company or the trustee, whichever shall have charge of putting out the issue, and a duplicate will be issued, when a provision to this effect is contained in the mortgage. It usually is.

When a serial number on a bond is altered or mutilated, it is not considered as in a material part when such number is used merely, as it usually is, for the purpose of identification. But when num-

bers are used to create different classes among the bonds of an issue, the bonds of one number or series of numbers possessing certain rights not given to the others, then the numbers enter into and become part of the contract contained in the bond and form a material part of it. The intentional alteration of serial numbers of a bond in such a case by its owner or with his consent or privity will annul the bond.

A purchaser in the open market is not bound to make a close and critical examination of a bond to avoid the charge of bad faith.

The same rules that have been stated here with reference to altered, changed or mutilated bonds apply also to altered, changed or mutilated notes or detached coupons. When the coupons are still attached to a bond or note they are incidents of the same and are affected by whatever affects such bond or note.

Coupon bonds and coupons.

A coupon bond consists of two parts; the bond itself, which represents the principal sum due, and the coupons which represent the interest thereon.

The coupon bond may be regarded as an invention of modern commerce. They are the result of the need in the money market of a security that can be circulated and pass from hand to hand without any formality of transfer, and as a substitute for money to a certain extent. It is because of their

great convenience in the financial world that the courts, when possible, will preserve this capacity for ready transfer, and give coupon bonds and coupons this easy marketability and currency.

The maturity of railroad bonds is fixed, as a rule, at far distant periods, averaging about fifty years. A set of certificates, one for each instalment of interest, from the time the bond is issued until the date of its maturity is attached to the bond. At the expiration of each interest period when the interest that the certificate represents becomes due, it is cut off and presented at the place designated for payment. These certificates may be detached from the bond and negotiated.

The term *coupons* from the French *couper*, to cut, has been universally adopted to designate these certificates because they are cut off when collected or negotiated.

How transferred; "clear" or "marked" bonds; presumption of ownership.

In its usual form a coupon bond is made payable to bearer, or payable to the order of a named payee, or the space left for the name of the payee may be left blank.

When the bond is payable to bearer, or the name of the payee is left blank, it is transferred from hand to hand by mere manual delivery without any writing or formality of any kind.

A holder of a bond with the space for the name of the payee left blank, has the legal right to fill in his own name as payee; while this is a legal right yet, if done, it will effect the bond commercially, for it is then a "marked bond," as the expression is used in financial circles and will not be accepted in transactions as a "good delivery," in that condition. It is no longer a "clear" bond.

When the name of the payee appears in the bond it can be transferred only by such named payee, who must deliver the bond accompanied with his written assignment of it.

The coupon bond that is transferrable by its manual delivery only, and which has never been registered, is known as a "clear bond," and is accepted in all transactions as a "good delivery." It should have no writing on it of any kind after it was put out. The holder should never deface his bond with any writing. Any memorandum may be written on a separate piece of paper and pinned on.

The law presumes that the transfer of a bond or its coupons carries with it the title of ownership. Every holder of a coupon bond or of a coupon, payable to bearer, is presumed to be its owner. This presumption, however, is not conclusive and may be shown to be otherwise. This presumption of ownership merely relieves the holder, when suing on his bond or coupon, or presenting it for payment, from proving his title in the first instance. He is pre-

sumed to be the owner until this is disputed; then he must prove his title.

Effect on coupons when severed from bonds.

Detached coupons, when negotiable in the strict legal sense, as previously discussed, possess to a great extent the characteristics of promissory notes. By such negotiability is meant that the coupons are payable to bearer, or to the order of a named payee and endorsed in blank by him; and that they contain an unconditional promise to pay a definite sum of money on a designated date. This is the form in which coupons are usually issued.

Should coupons comply with all these requirements, as they usually do, then when detached from their bonds they become independent securities, like so many promissory notes. They are then no longer mere incidents of their bonds from which they have been severed, but each is a separate contract, a distinct obligation of the issuing company. They become so far independent of the bond from which they have been detached as to continue their negotiability and, if for interest already accrued, remain in full force after the bond itself has been called in, redeemed, or for any reason paid or canceled before maturity. As to cessation of interest on bond called in, see *Redeeming bonds; calling bonds in.* Page 98.

When a negotiable coupon falls due and is not

paid, its holder is entitled to sue and recover on it. He may sue on each successive coupon as it falls due and is not paid. And the fact that the coupons sued upon are from bonds secured by a mortgage does not bar the suit; but in realizing on his judgment, the holder is not entitled to take any part of the property covered by the mortgage.

While the coupon negotiable in form is a contract in itself, separate and independent of the bond, the law holds that the recovery on it shall be based upon and be in conformity with the obligation contained in the bond.

Should the detached coupon, sought to be sued upon separately, be lacking in any of the elements of negotiability as previously described, a separate action will not lie upon it; it may then only be sued upon in connection with the bond from which it was severed and of which it is an incident. Some coupons do not contain promises to pay the sums therein mentioned, but are practically merely receipts for such amounts. Such coupons may not be sued upon separately, as they then lack the elements, so many times discussed, necessary to make them negotiable instruments.

A coupon which is not negotiable in the strict legal sense may be sometimes regarded as such, if the bond from which it was severed is itself negotiable. But on this proposition, the courts of the various States have decided differently. In some States, the law

is: that the coupon shall not be regarded as negotiable when severed, if it is not so itself, notwithstanding that the bond from which it was severed is negotiable, unless some statute makes it so. The courts of the other States hold that the coupons shall be taken in connection with the bonds from which they were severed, and though the coupon itself is not negotiable in form, if the bond be so, the coupon having acquired and possessed the same characteristics as the bond while attached does not lose these qualities by being severed, as the coupons are imbued with the strength of their bonds.

Should there be a conflict between the terms of the bonds and the coupons the terms of the former will prevail.

Collection of coupons.

To collect the interest which the coupon represents the holder must cut it off when due and present it at the place designated for payment. It is usually provided in the mortgage or deed of trust, that the trustee shall pay the coupons, or that the railroad company shall maintain an office or agency at which coupons may be presented for payment. Should no place be designated, the coupon is properly presented at the office of the railroad company. The coupon may be presented in person or through the usual course of banking, by deposit for collection. When the holder of the coupon is at a distance from the

place where it is payable, the usual and better course is to place it in the care of his local bank about a week before it is due. Institutions of this kind are equipped with better facilities for the collection of coupons than the private holder. The latter must resort either to the registered mail or express companies to send it to the place of payment.

To collect a coupon the original bond need not be presented. Coupons when negotiable, as previously described, become a separate contract and distinct obligation of the railroad company, and are paid without regard to the ownership of the bond. When the coupon is paid the company, or the trustees, whoever pays it is entitled to its possession and it must be surrendered, just as a promissory note or other commercial paper is turned over and surrendered when satisfied.

Presentation of coupons for payment; dispensing with presentation; effect of non-presentation.

The holder of a coupon does not lose his rights to its payment because he has not presented it for that purpose at the time when and the place where it is payable. The coupon is due and payable on the day fixed for its payment, and the obligation of the railroad company to pay the coupon is not discharged until it has actually paid it.

If the company had the money at the time and place designated for payment, the holder, while he

does not lose his right to payment of the coupon, will lose the interest on it, for unpaid coupons that have been severed from their bonds draw interest from the time of their maturity. See *Interest on over-due coupons.* Page 42. If the company had no money for the payment of the coupons at the time and place specified for payment, the coupons need not have been presented and there is no loss of interest on such coupon.

The holder of a coupon has the right without prejudice, except as to the possible loss of interest on his coupon, to await, without demand, the maturity of the bond and then collect his principal and interest, or at any intermediate time collect the interest then due. While these are his rights, it may be regarded as a rather unbusiness-like practise.

Effect of payment on coupons; cancellation.

The payment of a coupon extinguishes it.

Circumstances that tend to keep them alive as obligations of the railroad company should be avoided. When paid they should be cancelled.

There are cases recorded where coupons were taken up by third persons interested in the financial condition of the railroad company, under an arrangement with it by which such third persons advanced the necessary money and took up the coupons as they matured and held them as continuing obligations of the railroad.

The courts have held such a transaction to be a payment and an extinguishment of the coupons so taken up, so far as the holders of the bonds and the other coupons under the mortgage were concerned, where they were not parties to such an arrangement; but as between the railroad company and such third parties, the transaction is regarded as a purchase and not as a payment of the coupons so taken up, and that such third parties thereby became the owners of such coupons and therefore became creditors of the railroad company; but they are not then permitted recourse to the mortgaged property, and are not allowed to prove their claims against such property in competition with the holders of the bonds and the other coupons.

However, a railroad company may find itself temporarily embarrassed financially, and to stay legal action by holders of unpaid coupons, and prevent a foreclosure of the mortgage, it may arrange, with the consent of the holders of the bonds and of the later maturing coupons, that third parties may take up the coupons as they mature, and that the transaction shall take the form of a purchase and not be a payment of such coupons. Under such an arrangement the coupons are kept alive as outstanding obligations of the railroad company, and are secured by the mortgage and share in the security, the same as if in the hands of their original holders. This arrangement is sometimes provided for in the mortgage

itself, or it may be made upon a collateral consent of the holders of the bonds and the subsequently maturing coupons. And though no specific arrangement be made to that effect, yet if the holders of the bonds and of the subsequently maturing coupons have knowledge of such an arrangement between the railroad company and such third parties, and the surrounding facts and circumstances clearly show that it is the intention of all parties concerned that such transaction shall be a purchase of the coupons by which they are to be kept alive and share in the mortgage, the court will enforce such an understanding in favor of such third parties thus advancing these monies, and, accordingly, will permit them to share in the security of the mortgage with all the rights of holders of such coupons.

Overdue coupons; effect on bonds.

When the bond itself is due and not paid it is dishonored and is no longer a negotiable instrument. Then each subsequent holder of it takes it subject to all defenses and objections that might be set up either to defeat or diminish a recovery on it. It will be remembered that one of the elements of negotiability is that the instrument be purchased before maturity.

Whether or not the non-payment of a coupon attached to the bond will affect its bond not yet due with dishonor has been differently decided. And it

is of interest to examine the reasons upon which these different views rest.

The law seems in harmony on the point that when the principal of the bond is payable in instalments, it becomes dishonored by the failure to pay any one instalment. This rule, however, is not generally applied to the non-payment of interest and the failure to pay the interest-coupon attached to the bond does not of itself dishonor the bond. In one jurisdiction, this view is rejected and no distinction is recognized between failure to pay an instalment of interest and an instalment of principal. This court holds that if interest be over-due and unpaid, and this fact appears on the face of the bond as it does when the coupons remain attached, it is sufficient to put the purchaser on his guard that the bond has been dishonored by the non-payment of the coupon, and the bond will be then subject to all defenses that may defeat or diminish its payment.

The decisive weight of authority, however, regards coupon bonds as a class of negotiable securities, the principal of which is payable only at the end of many years, with interest payable periodically; and that the holder of such bond may wait until the maturity of the bond itself before he demands any interest. Unpaid coupons attached to the bond, therefore, do not affect the bond. The ease with which the over-due coupons can be removed from a bond not yet due, before transferring it, and thereby avoid

the objection to their presence, would tempt the frequent commission of fraud. Further, a railroad company may not put out the bonds until one or more coupons are past due. While it is the custom to cut off the over-due coupons, under such circumstances, they may be permitted to remain, though it is quite unusual to do so, and their amount included in the purchase price.

It may be said as a general proposition that the presence of over-due coupons on a bond is not sufficient in itself to dishonor the bond; yet, the fact that the interest is overdue is material and important, and will be considered in connection with other circumstances as evidence of the good or the bad faith of the purchaser.

Interest on overdue coupons, attached and detached; rates of interest allowable.

Detached coupons when negotiable in form, as was seen, are regarded as securities so separate and distinct from their bonds that they may be sued upon independently of and without the production of the bond. And under certain circumstances they draw interest like other obligations for the payment of money.

As a general rule, interest is allowed only on principal. But this rule has been modified somewhat in the case of coupons, negotiable in form, that have been detached from their bonds and negotiated, be-

cause when negotiable in form and detached and negotiated they are separate and independent securities. Under such conditions they draw interest from the time of their maturity like other securities.

Interest on overdue coupons, detached from their bond, though it is interest on overdue instalments of interest, is not regarded as usury.

But when the coupons, whether remaining attached to their bonds or detached therefrom, are in the possession of the holder of the bond itself, a different question presents itself. While there is a conflict in the decisions of the courts of the different States on this point, the weight of authority holds that when the coupon remains in the hands of the holder of the bond, whether attached or detached, they are merely incidents of the bond and are promises for the payment of its interest. The coupon, under such circumstances, is regarded strictly as interest and not as a separate security, and no interest will be allowed on this overdue interest. But when the coupons are negotiable in form and have been detached and are held by one other than the holder of the bond itself, interest is allowed on them from the dates of their maturity.

The rate of interest on the overdue coupons may be fixed in the mortgage, or by other arrangement between the parties, and the rate of interest thus agreed upon will be enforced provided it does not violate any law.

Where there is no provision made by the parties, the rate of interest on the overdue coupons, in most States, is the legal rate of interest at the place where they are payable, without regard to the rate of interest the coupon bears.

However, the courts of some States hold that the rate of interest payable on coupons after maturity, where there is no provision to the contrary, shall continue the same as they bore before maturity. Notwithstanding this latter ruling, should a coupon holder sue and reduce his claim to a judgment, his judgment thus obtained (which has merged and disposed of his original claim on his coupon), will bear the legal rate of interest fixed by the law of the State in which the judgment is had. This rule with regard to the rate of interest that judgments shall bear is the same in all the States.

The security for the coupons; priorities and preferences.

The coupons are secured by the same mortgage that secures the bonds.

The bonded debt of the railroad company consists of the bonds and the interest. The interest-coupons, therefore, are a part of that debt. An assignment of a part of the mortgage debt, such as a bond or a detached coupon, carries with it a corresponding interest in the mortgage security. Consequently the holders of detached coupons are entitled to share in

the proceeds of the security proportionately with the holders of the bonds.

Claims for interest that accrue during the foreclosure are entitled to the same rights as claims for the interest theretofore due and unpaid. Should the money realized from the sale of the mortgaged property be insufficient to pay all in full, then the coupons and the bonds bear the loss proportionately, unless there is some arrangement agreed upon to the contrary. Then such other arrangement will be enforced.

Ordinarily, coupons are paid in the order in which they fall due. But, in foreclosure proceedings they are paid without regard to when they fall due, and all stand on the same footing. Then priority in their maturity gives no priority in their payment.

In applying these rules, the courts give effect to the equitable principles of law which give equality among persons having a common right to payment out of a fund provided for the benefit of all. And this rule is not departed from without clear evidence of an intention to give one a preference over the other.

Provisions for preference may be and sometimes are made in railroad mortgages. Accordingly, a railroad mortgage, securing several classes of bonds and their coupons, may give certain priorities and preferences in payment to one class over another; or it may prefer the coupons over the bonds themselves;

or it may prefer coupons in the order in which they fall due; or it may make such other arrangement as has been agreed upon by the parties. The courts recognize and enforce such stipulations in railroad mortgages.

Rights of coupon holders as to each other; bona fide holders of coupons.

Coupons may be affected by the original invalidity of their bonds; but, as among themselves, one coupon is not affected by any claims or defense that may exist against the others.

When the coupon is entitled to stand as a separate and independent negotiable security, it is protected by law in the hands of a bona fide holder, so that it shall be subject in his hands only to such defenses as deny its legal existence, that is, showing the non-existence of the facts necessary to give it legal life, such as forgery, lack of power to make the issue, that the coupon was not delivered, that it is not properly certified by the trustee, or that his certificate is forged. The same rules apply to negotiable coupons as to negotiable bonds. See *Rights of bona fide holders of negotiable bonds.* Page 23.

Statutes of limitations; as to the bonds, as to the coupons.

A party having the right to sue must not sleep on his rights; he must bring his action into court with

reasonable diligence. The statutory laws of the various States have classified the different kinds of actions and have declared the periods within which each class shall be commenced. Actions on written instruments which have been executed by the party sought to be charged by putting his seal to the paper, must be sued upon, as a quite general rule, within twenty years from the time that the right to sue first existed. Actions on written instruments, to which the seals of the parties to be sued have not been attached, must be sued upon, as a general rule, within six years from the time the right to sue first existed. Should the action be brought after such period has expired, it may be defeated by the defense that it is "outlawed" by the statutes of limitations, as these statutes are called.

The statutes of limitation begin to take effect or to "run," as the expression is, from the time that the right to sue first existed; which, in the case of bonds and detached coupons, is from the time they became due and payable, according to their terms, and were not paid. Should a demand be necessary, the statute begins to run from the time the demand was made and not complied with.

A railroad bond is a written instrument executed under the seal of the railroad company and, therefore, the twenty years statute of limitation applies.

The same statute of limitation of twenty years is applied to detached coupons. Ordinarily, the

coupon is a written instrument not under seal, and it seems, therefore, that the six years statute should apply; but the courts have held that the coupon so strongly partakes of the nature of the bond from which it has been severed that the twenty years statute shall apply. But the time in the case of detached coupons from which the statute of limitations shall begin to run is from the time such coupon was payable, without regard to the maturity of the bond or when the bond became payable.

Registered bonds; the act of registration; effect on principal and on interest.

While the coupon bond has the advantage of easy negotiation, and therefore commends itself to those seeking a security that may be quickly transferred and readily converted into cash, and which is often accepted as the representative of money, it has the disadvantage of the risks that attend its loss or theft. The registered bond, therefore, is sought by those seeking a permanent form of investment. The danger attending loss, destruction, or theft, is avoided in the registered form of bond.

A registered bond is one that bears the name of its payee on its face, and is registered in the name of its payee on the books of the railroad company, or of the fiscal agency designated for that purpose.

Railroad mortgages invariably provide that the person in whose name the bond shall be registered,

so far as the railroad company or the trustee shall be concerned, shall be regarded as its owner, and that payment of all or any part of the bond shall be made only to such registered owner or his order. The interest and the principal of the bond is paid only to him who appears on the registry as owner of the bond.

The registered bond has no coupons.

A registered bond may be issued in the first instance; or the holder of a coupon bond, under the privilege usually granted him by railroad mortgages, may have it registered.

The holder of a coupon bond who wishes to register it presents it to the railroad company or the fiscal agency, when one is designated for that purpose, whereupon the coupons are cut off and surrendered. The name of the holder is then entered on the registry or books kept for that purpose and an indorsement made on the bond noting its registration; or a new bond may be issued, with the name of the registered owner appearing on its face as payee.

When the new registered bond is issued in the place of the surrendered coupon bond, the latter is destroyed. When the coupon bond is not surrendered, the coupons are cut off, and the body of the coupon bond is used and the notation made that it is registered in the name of the registered owner, as payee. The body of the coupon bond is the same

as that of the registered bond, with the exception of those facts that show the registration, and also that the coupons are missing.

Should no fiscal agency be designated, then the bond is presented for registration to the railroad company at its general office. Should the person desiring to register a bond live at a distance from the place of registration, the practise usually followed is to send the bond by registered mail or express. The local banks or bankers take care of such matters for clients.

Transfer of registered bonds; converting registered bonds into coupon bonds; payment of interest.

The transfer of a registered bond is made by the last registered owner executing a written assignment or power to transfer the same, in a form approved by the railroad company, and delivering both to the new owner. Some bonds have the form printed on their backs.

Until this is done the bond is like a check, payable to a named payee and which has not been endorsed and transferred by him.

The bond is in turn registered by the person to whom it has thus been transferred by the registered owner by presenting it at the place for registration for that purpose.

It is usually provided in railroad mortgages that, after registration, no transfer shall be valid so far

as the railroad company is concerned unless made on its books and by the registered owner in person, or by his attorney duly authorized in writing, and similarly noted on the bond.

The stock exchanges and the registries of some of the railroad companies have rules with regard to the transfer of registered bonds that they insist shall be strictly observed. A disregard of these requirements, even in the slightest detail, may cause annoyance by the delay in correction. Registered bonds, as a rule, are not regarded as "good deliveries."

Where the bond is registered in the name of a person since deceased, the endorsement, assignment, or power of attorney should be made and executed by the executor or administrator, as the case may be.

Registered bonds may be presented to the railroad company, or its fiscal agency designated for that purpose, should the terms of the mortgage grant this privilege, to have noted on them that they are payable to bearer. Their negotiability is thus restored and they may then be transferred by their manual delivery from hand to hand, without any indorsement, written assignment, or power, or any formality other than their physical delivery, just as if they were coupon bonds originally and had never been registered. A new set of coupons are then issued to accompany the bond.

Interest on a fully registered bond is paid when due directly to the registered owner of the bond; there is no need for presentation of the bond itself. The custom is to draw a check to the order of the last registered owner and mail it to him to his address as it appears on the registry. The payment of principal or interest, or both, may be made to another pursuant to the order of the registered owner.

Where the bond is registered as to principal only and the coupons are not destroyed but permitted to continue as representative of interest, then such coupons are transferrable, after they are severed from the bond, by their manual delivery, just as if they were the coupons of a coupon bond. The principal only is paid to the registered owner and the interest is paid to whomsoever presents the coupon without regard to the ownership of the bond itself.

Registration of coupon bonds as to principal only.

The coupon bond may be registered in its entirety, that is, as to both principal and interest as just discussed; or it may be registered as to the bond (principal) only, and the coupons permitted to remain negotiable as theretofore. Then the principal of the bonds is payable to the registered owner and the coupons are paid to their holder or holders without regard to the ownership of the bond or its registration.

The coupons continue their currency and may be circulated as if the bond had not been registered.

Registration of both bonds and coupons.

A form of registration rarely used is that by which the bond itself is registered and the coupons are also registered. Then principal and interest are paid only to the registered owner of each. The only difference between this kind and the usual form of registered bond is in the mode of collection of interest. The interest of the ordinary registered bond is sent to the last registered owner of the bond; the interest on the bond registered both as to the bond and the coupons is collected by means of the coupons. The interest is paid to the registered owner of the coupons.

When the set of coupons become registered and this fact is noted on their face, they lose their negotiability and capacity to pass title by delivery from hand to hand, but must then be assigned in writing as in the case of the bond itself, and the provisions for the registration by subsequent holders or owners of the bonds apply to the same situation with relation to the coupons. See *Registered bonds: the act of registration; effect, etc.* Page 48.

Interchangeable or convertible bonds.

The privilege to change or convert a coupon bond into a registered bond, or to re-convert or change

back the registered bond into a coupon bond, is quite generally conferred by railroad mortgages. Bonds with these privileges are usually called "convertible bonds." The same term is also employed to designate a bond which gives its owner or holder the right to convert it into the capital stock of the issuing company. See *Provisions for converting bonds into capital stock of the railroad company.* Page 105.

Should the owner of a registered bond desire to change it into a coupon bond, he must have a new coupon bond issued to him, or at least a new set of coupons must be issued and a notation made on the old bond that it is thenceforth payable to bearer.

When the coupon bond has been registered in the ordinary form, that is, as to principal and interest, it is shorn of its coupons. Having been thus converted from a coupon bond to a registered bond it cannot be reconverted into a coupon bond because the coupons, which are an indispensable part of a coupon bond, no longer exist. A new set of coupons are necessary. The usual custom is to surrender the old bond and a new coupon bond is issued in its place, with the matured coupons cut off.

A bond registered as to the bond (the principal) only, with the coupons continuing their negotiability may be reconverted into an ordinary coupon bond without much difficulty. This is done by an endorsement on the bond by the registered owner that it is payable to bearer, and by a similar notation

by the railroad company or its representatives at its fiscal agency. The negotiability of the bond which as to its principal had been temporarily withdrawn is thus restored.

Railroad bonds are usually secured by a mortgage or "deed of trust," as it is sometimes called. These terms are used interchangeably. The following chapter is addressed to an analysis of the usual form of railroad mortgage and a discussion of its various provisions, including the lien of the mortgage and the protection and rights it gives the holders of the securities issued under it, under various conditions, and, treating, too, of the sinking fund, refunding, redeeming, calling in, serial payment, and conversion arrangements.

CHAPTER III

RIGHTS AND REMEDIES WITH RELATION TO THE MORTGAGE OR DEED OF TRUST

Purpose of the mortgage or deed of trust.

The mortgage, or deed of trust as it is sometimes called, is the instrument or document that secures the bonds and their interest by charging certain property of the railroad company with their payment.

In some States the mortgage or deed of trust is unnecessary as their statutes declare that the bonds of railroad companies shall be a lien upon all its property from the time of their issue without any mortgage.

The terms "mortgage" and "deed of trust" are used interchangeably. They mean the same document or legal instrument. The more popular term is mortgage, and it will be used in these pages.

The mortgage pledges the property therein mentioned, and charges it with a lien in favor of the bonds and coupons it secures, so that their holders shall have the exclusive right to take this property in satisfaction of their claims, and be paid out of it in full, before any other creditor, who is not secured

by a lien on this mortgaged property prior or superior to that of the mortgage, receives anything.

General description of the mortgage.

The mortgage is executed by the railroad company, as mortgagor, to the trustee, as mortgagee. The bondholders are not directly made parties to the mortgage; but it is with the same effect as if each bondholder were made a party to it. The trustee is the party to the mortgage in behalf of the bondholders. The mortgage is enforced by the trustee for the benefit of whomsoever may be the holders of the outstanding bonds and coupons under such mortgage at the time it is enforced.

The trustee, generally speaking, represents all the holders of the securities under the mortgage. He is their trustee: the guardian of their rights with relation to that mortgage. The mortgage is made to him as a party instead of to the bondholders directly, because trusteeship of this character is necessary when a mortgage is given to secure a large issue of railroad bonds. It would be impracticable to make each bondholder a party to the mortgage, as each transfer of a bond would necessitate the transfer of the owner's interest in the mortgage. This bewildering number of transfers would retard the ready negotiation of railroad bonds secured by mortgage, and correspondingly impair their value. It would be impracticable to have this large num-

ber of bondholders, unknown to each other, and scattered over the civilized world, unite to take legal action. It becomes necessary, therefore, that one or several representatives shall be chosen to act for all. Hence the trusteeship of railroad mortgages.

The effect of the mortgage is to pass the title and ownership of the property it covers (usually the entire road or a branch line, and sometimes other property as stocks and bonds of other companies, etc.) to the trustee; by a provision in the mortgage the railroad company is permitted to retain possession of the road that is mortgaged, and to use and to operate it, and is entitled to the income it earns until it defaults under the mortgage. By a default is meant a failure to pay the interest, or the principal of the bonds, or an instalment of principal; or an omission on the part of the railroad company to do something it has undertaken to do in the mortgage, which is generally an act intended to safeguard and to protect the mortgaged property so that the security of the bondholders will be preserved to them; or the doing of some act with respect to the mortgaged property that jeopardizes the security. Upon such a default the mortgage usually authorizes the trustee to take possession of the mortgaged road (if securities are mortgaged they are turned over to the trustee upon the execution of the mortgage) and to operate such mortgaged road and, if necessary, to sell it to satisfy the claims of his bondholders

against it; he may sell sometimes without entering into possession and operating it. The securities that have been turned over to him under the mortgage are sold by him; should the deposited securities consist of bonds of other companies secured by mortgages on their property he may have to foreclose the mortgage securing such deposited bonds, should the company issuing them default under their mortgage.

In addition to these special powers that railroad mortgages usually grant trustees, he may apply to the court to foreclose the mortgage and sell the property under its direction asking that, in the meantime, a receiver be appointed to take possession of the mortgaged road until it is sold on foreclosure sale, or until the property is taken over in the course of the reorganization of the road. While the receiver holds such mortgaged road, he is usually authorized by the court to operate the road.

Power of railroad company to mortgage its property and its franchise to operate; opinion of counsel.

In some States, railroad companies have the same powers as ordinary private corporations to mortgage their property, including their franchise to operate, for any lawful purpose necessary to carry out the objects for which they were incorporated, unless this power is expressly negatived by its charter.

In other States, and by the weight of authority,

railroad corporations do not have this same power that ordinary private corporations have, and may neither mortgage their franchise nor their property where its sale would interfere with the operation of the road, unless this power is granted by their charters.

These latter authorities rest their conclusions upon the distinction that railroad corporations are "quasi public" corporations, immediately connected with the public welfare, serving public needs and necessities; that they receive from the people of the state the necessary franchises or special privileges to run their roads between certain terminii and over certain territory to the exclusion of others; that by accepting these franchises they assume the duty to maintain their roads and to continue them in existence and operation; and that they may not by mortgage or sale of their property or franchises abandon or interfere with the performance of these duties, unless the State from which they receive them consents.

The State having granted this exclusive privilege to operate a railroad between certain terminii and over certain territory to one corporation to the exclusion of others continues to regulate its exercise. As the mortgage may result in a sale, the franchise may not be mortgaged without the permission of the legislature that granted it. However, the power to mortgage their franchises to operate is usually given

to railroad companies by the legislatures of most States.

The franchise referred to in the preceding discussion is the special privilege to operate a railroad. It must be distinguished from the franchise to exist as a corporation.

The franchise to exist as a corporation is the right the legislature grants to do business of a designated nature to the requisite number of persons who have complied with certain requirements of the statute laws of its State. A legal body is thus created that becomes a distinct legal entity, separate from its stockholders. This legal body holds property, makes contracts, and does all other acts necessary to carry on the business for which it was incorporated. When it is incorporated to transport persons and property, carrying on the general business of a railroad company, the State gives a special privilege or franchise to operate a railroad, which other corporations do not have by mere reason of their incorporation. This franchise to operate a railroad between certain points and over certain territory is exclusive and limited to this corporation to which it is granted. This franchise to operate a railroad is property and like other property is separable from the corporation that owns it.

The question of the power of the railroad company to execute the mortgage is passed upon by well known and reputable lawyers, whose written opinion

usually accompanies the mortgage. This opinion is to the effect that the railroad company has been legally organized, that it had legal power to issue the bonds in question, and also the mortgage to secure them, that such bonds have been legally issued and are valid obligations of the railroad company, and that the mortgage is in proper form to entitle the holders of the bonds to the protection of the security pledged by it.

Where the railroad company had the power and authority to issue the bonds, the bondholders are entitled to assume that all the requirements of its charter and the laws of the state with respect to the issuance of the bonds have been complied with. This ruling has been made necessary by a consideration of the nature of railroad bonds, and the objects they are intended to serve, for it would defeat their very purpose if one were compelled to inquire as to these facts when about to purchase a railroad bond in a distant State, or perhaps a foreign country, offered for sale in the market.

The lien that the mortgage gives the bondholders; liens generally discussed.

The mortgage creates a lien on the property it covers in favor of the trustee, but in behalf of the holders of the outstanding securities under it and for their benefit.

By a lien is meant that the property to which it

attaches is charged with a special obligation to those in whose favor it exists.

The effect of the lien of the mortgage is to take the property against which the mortgage exists and reserve it to satisfy in full the bonds and coupons it secures, before creditors with later liens against the same property and creditors with no liens receive anything out of it. However, all claims under liens prior in point of time, or liens superior by reason of their nature, must be satisfied in full out of the mortgaged property before bondholders receive anything under their mortgage.

Liens exist, generally, in favor of recorded mortgages, taxes, judgments, etc.

Liens, generally speaking, have priority according to the time they attach to the property, except those liens which by reason of their nature, usually take precedence over all mortgages or other liens without regard to the time when they attached, such as liens for taxes and other governmental charges. See *Taxes*, *Assessments*, *Governmental charges*. Page 254. The courts may, also, under some circumstances, order that receiver's certificates and claims for "operating expenses" be paid out of the mortgaged property before the bonds under the mortgage receive anything therefrom. See *Receiver's certificates, etc.* Page 210. And see *Operating expenses prior to receivership.* Page 245.

The legal effect of a lien against railroad property

is determined by the law of the State where the property is located upon which the lien is sought to be enforced. The lien of the mortgage attaches when the mortgage is recorded in the office of the public official designated for that purpose by the law of the State where the property is situated. These public officers are either the clerk or the register of the county or the secretary of the State in which the property is situated. The lien of a judgment attaches to the property of the road from the time such judgment is docketed in the office of the clerk of the county, and therefore attaches to the property of the road situated in that county. A transcript of such judgment may be filed in other counties of the State and thus reach the property in such other counties.

Recording the mortgage.

Recording the mortgage means that it is copied at length in books kept for that purpose in the office of the public official charged by law with that duty. It is then a public record and all may examine it.

The purpose of recording, filing, or registering, the mortgage, as these acts are interchangeably called, is to give notice to all persons dealing with the property, either as creditors of the corporation or as purchasers of that property, that it is charged with certain payments and obligations, and that any rights they may acquire with respect to that prop-

erty must be subject to and inferior to this prior charge.

In some States there are statutes which provide for a special manner in which railroad mortgages may be recorded.

These special statutes for recording are usually to the effect that the mortgage shall be recorded with a State official, such as the secretary of State, and thereupon the lien of the mortgage shall attach to all the property it covers located in that State. This dispenses with the need of recording the mortgage in each county of the State in which the property is situated.

Statutes in some States make a railroad mortgage a lien on the property it covers without recording.

Where there is no statute for special recording, nor for making it a lien without recording, the mortgage must be recorded in the office of the public official designated by law for that purpose, usually the clerk of each county in the State in which the mortgaged property is situated. To facilitate recording of mortgages where the property is situated in several counties or States, a number of originals are executed simultaneously, all being recorded as the same document. They are duplicate originals.

Where a railroad mortgage covers both real estate and personal property, it is recorded both as a real estate and a chattel mortgage.

Failure to record, or to properly record, the mort-

gage does not affect the rights of the bondholders and their trustee in the mortgaged property so far as the railroad company is concerned; but as to third persons a situation entirely different presents itself. See *Defective mortgages; partly defective.* Page 67.

Valid bonds as affected by defective mortgages; void bonds.

If the bonds be valid, the fact that the mortgage given to secure them is void will not affect them in any way.

The mortgage affects the security only and if void will deprive the bondholders of their security. But the bonds (the obligation of the issuing company to pay) will remain fully valid and effective. The invalidity of the mortgage will not taint the bonds, for the obligation to pay the debt they represent continues; the attempt to secure them has failed. The debt remains the same though the security has been lost.

Where, however, the bonds are void the mortgage though executed according to form and all the requirements, and properly recorded, is void.

The mortgage is given to secure an existing indebtedness represented by the bond, and when such debt is void and does not legally exist, there is no debt to secure, and the attempt to mortgage is of no effect.

That some of the bonds secured by the mortgage are invalid does not, as a general rule, affect the validity of the mortgage nor any legal action under it. The mortgage continues to secure those bonds that are valid.

Defective mortgages; partly defective.

Railroad mortgages executed contrary to law or without power are void.

A railroad mortgage covering several parts or divisions of a road may be void as to some of them and valid as to the others.

Should the mortgage attempt to include some property that the railroad company had no power to include, the mortgage is nevertheless good as to the property it had authority to include, though void as to the other.

Synopsis of railroad mortgage.

The following is a synopsis or outline of the usual form of railroad mortgage. It contains those provisions commonly found in railroad mortgages and, in addition, sinking fund, redeeming, calling in, refunding, and conversion into capital stock of the railroad company arrangements, besides those other special provisions that the particular circumstances of an issue may require.

(a) The mortgage recites the parties to it. Purposes of the mortgage.

The parties are the railroad company and the trustee. The bondholders are not made parties to the mortgage directly. See *Reasons for trusteeship.* Page 117.

The purposes for which the money is to be raised are set forth. These are usually to transact the regular business of the corporation and to exercise its corporate rights and privileges, or to carry out any lawful purpose of its incorporation: and to discharge underlying liens, when the issue is of refunding bonds.

(b) Consents of stockholders, directors, public commissions to the issue of bonds and the mortgage.

The consent of the holders of the requisite proportion of the stock of the railroad company to the execution of the mortgage and to the issuance of the bonds is then stated in the mortgage, and, too, that at a special meeting, called for that purpose, the board of directors approved the mortgage and passed its resolution that the railroad company execute it.

In nearly all the States there are statutes which provide that a corporation shall not execute any mortgage on its property without the consent of the holders of a specified proportion of its capital stock. The requisite proportion is usually two-thirds of the

amount of its outstanding stock. In some States the consent of the board of directors is also necessary.

Should the mortgage be executed without the requisite consent of the stockholders, neither the railroad company nor any of its creditors have any standing to dispute the validity of the mortgage on this account. This requirement is for the benefit and protection of the stockholders and can be taken advantage of only by them. But the stockholders may lose their right to object to a mortgage lacking this consent, by their unreasonable delay in attacking it or by permitting the railroad company to accept the proceeds under it.

Under the laws of most of the States a statement, setting forth the basis or financial plan upon which the bonds are to be issued, must be submitted to a public board or commission which must approve the issue before it is put out. A recital that this has been done is invariably included in the mortgage.

(c) Amount of the issue; limitations; protection against over-issue; closed mortgages; open-end mortgages; open mortgages.

The amount for which bonds may be issued by a railroad company is sometimes limited by statute. These statutes are usually to the effect that the total amount of the outstanding indebtedness of the company shall not exceed a certain specified proportion of its capital stock or property.

Bonds issued in excess of the limitations fixed by statute are void.

Where the railroad company issues bonds in excess of the amount limited in the mortgage, but not in excess of the amount limited by a statute, such excess issue is good and fully enforceable in the hands of a bona fide holder, and are entitled to share in the security with the other bonds. Excess issues are guarded against by provisions for authenticating each bond by a certificate of the trustee.

The mortgage, therefore, invariably provides that the trustee shall authenticate each bond by endorsing or attaching his certificate to the effect that such bond is one of the issue secured by the mortgage, and that its holder is entitled to the benefits of the mortgage and of the trusteeship. No bond is valid for any purpose where such a provision is contained in the mortgage, as it invariably is, without this certificate of the trustee. Should such certificate be forged the bond is void though in the hands of a bona fide holder for value. It is usually provided in the mortgage that the bonds shall be turned over to the trustee and put out by him after his certificate has been endorsed or attached. Sometimes after he has certified to the bonds the trustee turns them over to the railroad company, under the terms of the mortgage, and it puts them out.

The aggregate amount of the issue is usually speci-

fied and limited in the mortgage. All the bonds of the issue, however, need not be put out at once.

Where the money is raised for construction, bonds for a specified amount are usually put out, from time to time, as the work progresses.

Part of the authorized amount of an issue may be reserved to retire bonds or notes or underlying liens soon to fall due; or provision may be made to issue a fixed amount each year, or at some other specified time; or the entire amount may be put out at once or in such amounts and at such times as the railroad company shall require for its business.

When the aggregate amount of the issue is limited and is put out all at once it is generally called a "closed mortgage." When the aggregate amount is limited but is not put out all at once, but from time to time, at specified periods or on certain occasions, and in amounts agreed upon in the mortgage, it is an "open end mortgage." The amount of the entire issue secured by an "open end mortgage" is limited but is put out, from time to time, according to the terms of the mortgage.

The "open mortgage," so called, is one wherein there is no limit on the aggregate amount of bonds that may be issued under and secured by it. This kind is rare.

The favorite form of mortgage is the open end mortgage for under it the company may raise money

for present requirements and anticipate future needs. See *General mortgage bonds; blanket mortgage bonds.* Page 269.

(d) Description of the bonds of the issue to be secured by the mortgage.

No. $

United States of America
State of

The Railroad Company, First Mortgage, Five Per Cent., Fifty Years, Refunding Gold Bonds.

The Railroad Company, a corporation organized and existing under the laws of the State of , for value received, hereby agrees to pay to bearer, unless this bond is registered, then to the registered owner thereof, on the day of , 19 , the sum of dollars, in gold coin of the United States, of the present standard of weight and fineness, at the office or agency of the Railway Company, in the City of New York, together with interest thereon at the rate of five per centum per annum from day of , 19 , payable at the same place in like gold coin on the days of and , in each year, on presentation and surrender of the annexed coupons as they severally become due.

This bond is one of a series, of like tenor and date, numbered consecutively from one upward, issued and to be issued under and in pursuance of, and all equally secured without priority or preference by a mortgage or deed of trust to the Trust Com-

pany, of New York, bearing even date herewith, of all the line of railroad of said Railroad Company now built or to be built, and the franchises authorizing the construction and operation thereof now owned or hereafter to be acquired, as therein set forth.

The principal of this bond may in the manner and with the effect prescribed by the said mortgage or deed of trust, be declared to be due by reason of six (6) months' default in the payment of interest or of six (6) months' default in the performance of any other obligation imposed by the said mortgage or deed of trust on the said Railroad Company.

No recourse shall be had for the payment of the principal or interest of this bond, or for any claim based thereon or in respect thereof or of said mortgage or deed of trust, against any stockholder, officer or director of the said Railroad Company, whether by virtue of any statute or by enforcement of any assessment or penalty or otherwise; but this provision shall not be held to exempt any officer or director from liability resulting from any fraud or wilful neglect.

Both the principal and interest of this bond are payable without deduction for any tax or taxes which the Railroad Company may be required to pay or retain therefrom under any present or future laws of the United States of America or of any State, county or municipality therein, said Railroad Company hereby agreeing to pay all such tax or taxes.

This bond may, at any time, upon production thereof to the said Railroad Company, and prior endorsement being made thereon, be registered in the owner's name on the books of the said Railroad Com-

pany. After such registration, no transfer of the bond shall be valid unless made on the said books by the registered owner in person or by his attorney duly authorized, and similarly noted on the bond. This bond may be discharged from registry by being in like manner transferred to bearer as before. The registration of this bond shall not affect the negotiability of the coupons, which shall continue to be transferable by delivery.

This bond shall not become obligatory until the certificate endorsed hereon is signed by the said trustee or its successors in the trust.

(*Note.* If the issue is for refunding purposes, the statement will be found here that a certain proportion of the bonds shall be issued only in exchange, bond for bond, for the underlying issue to be retired, under the conditions described in the mortgage; or such other plan of refunding as the mortgage shall contain, will be set forth. See *Refunding plans.* Page .)

(*Note.* If the bonds are to be called in for the sinking fund, the provisions therefor are included here. See *Sinking fund arrangements.* Page .)

(*Note.* If the railroad company reserves the right to call in the bonds at the expiration of any period, the provisions therefor are inserted here, with the price at which they shall be called in or redeemed. See *Redeeming bonds; Calling bonds in.* Page .)

(*Note.* Provisions for converting the bond into the capital stock of the Railroad Company are inserted here, if that be one of the features of the issue. See *Provision for converting bonds into capital stock of the railroad company.* Page .)

(*Note.* Should the Railroad Company, as it

usually does, waive the benefit and advantage from any and all stay, extension, redemption, valuation or appraisement laws then or thereafter in force, a provision to that effect is inserted in the bond.)

In Witness Whereof, the Railroad Company has caused its corporate seal to be hereunto affixed and the same to be attested by the signatures of its President and Secretary on this day of , 191 .

The Railroad Company,

by

Attest: President.

(Seal)

Secretary.

(Form of Coupon.)

No. $

The Railroad Company will pay to bearer, on the day of , 19 , free from taxes, Dollars in United States Gold Coin, at its office or agency, in the City of New York, for semi-annual interest, on its First Mortgage, etc., Five Per Cent., Gold Bond, No. , unless the said bond shall have been called in for previous redemption. (See *Redeeming bonds; Calling bonds in.* Page 98.)

Treasurer.

(Trustee's Certificate.)

This is one of a series of bonds described in the Mortgage or Deed of Trust, referred to in the within bond. (See *Amount of issue*, etc.; *protection against over-issue, etc.* Page 69. Also see *Trustee's certificate.* Page 70.)

Trust Company. Trustee.

by

Vice-President.

(e) Direct obligation of the railroad (issuing) company; stockholders, officers or directors not liable.

The issuing company promises to pay the principal and interest of the bonds according to their terms and tenor; this makes it the *direct* obligation of the issuing company as distinguished from the collateral obligation of a guarantor. By the direct obligation is meant that the railroad company is liable to pay in the first instance, that it owes the money directly; by the collateral obligation is meant that the party is liable to pay only when the one directly liable fails to do so as in the case of one company guaranteeing the bonds of another.

Many mortgages provide that no recourse shall be had for the payment of the principal or interest of the bonds, or for any claim based on them, against any stockholder, officer or director of the railroad company, either directly or through the company. There are statutes in some of the States to the effect that the directors and sometimes the other officers of the corporation shall file annual reports, and for their failure to do so, certain penalties, such as fines or other liabilities, are imposed. It is against such and similar statutory penalties that it is thus agreed that the holders of the bonds or coupons shall not have recourse.

However, should any officer or director act fraudulently or wilfully neglect his duties, and the bond-

holder be injured thereby, he may then, notwithstanding these provisions, have his action against the offending officer or director. And the fact that the bond may expressly give him such rights adds nothing as he has this remedy without the provision to that effect.

(f) Property is transferred to the trustee to secure the bonds, etc., upon conditions, etc.

The mortgage conveys to the trustee the property that is pledged to the payment of the issue. A detailed statement of the property is set forth in the mortgage.

This property is conveyed to the trustee absolutely, but this absolute conveyance is later qualified in the mortgage by a provision that the property shall be held by the trustee *in trust* and upon certain conditions there mentioned.

This trusteeship thus created is to the effect that the trustee shall hold the property and exercise his rights and remedies in relation thereto, in behalf of the bondholders under the mortgage, and as the railroad company still has some interests in the property, with due regard to such interests.

The conditions upon which the trustee takes the property under the mortgage are that if the railroad company shall pay the principal and interest on the bonds and perform all its other obligations which it has assumed under the terms of the mortgage and

the bond, then the conveyance of the property to the trustee falls and it once more belongs absolutely to the railroad company.

(g) The railroad company remains in possession of the mortgaged road, and other property, except securities, and agrees to keep same in proper condition, etc.

When stocks, bonds, or other securities, are conveyed by the mortgage as security, they are delivered to the trustee; he holds them for the purposes of the trust created by the mortgage.

The voting power on the stocks thus deposited with the trustee is arranged for in the mortgage; the disposition of the dividends on such stock is also provided for in the mortgage as is also the interest on such bonds, notes, or other interest bearing securities that have been thus deposited.

The usual provision is that the railroad company shall vote the deposited stock and receive all dividends thereon, and the interest on the interest-bearing securities, until it defaults under the mortgage; that after it defaults the trustee shall exercise the voting power on the deposited stock and shall then also receive all dividends thereon, and also the interest on the interest-bearing securities that have been deposited.

Where real estate and personal property, other than securities, are conveyed to the trustee by the

mortgage, it is usually provided that the railroad company shall continue in possession and use the same until it defaults under the mortgage, but upon such default the trustee shall be entitled to physical possession of such property to realize on it for the payment of the sums due under the mortgage. The railroad company is also granted the right to take and to use the income of the road during the time it thus operates and until the default.

This exemplifies the difference between the ordinary pledge and mortgage. In the case of a pledge, the property passes from the pledgor into the possession of the pledgee, to be held by him until the pledgor pays the money due or performs such other acts to secure which the property has been pledged. Should the pledgor fail to pay or to do the other acts thus secured, then, upon his default, the pledgee sells the property and reimburses himself out of the proceeds for any loss he may have sustained. Should the pledgor pay the money due or perform the acts required, then the pledged property is returned to the pledgor. In a pledge the property must actually pass. The pledgee must have actual possession. Under a mortgage, the property is also charged with specified obligations, and the title and possession are also conveyed to the mortgagee (the trustee) to whom the property is pledged; but it is invariably provided that though the title and ownership of the property thus pass, the right to the posses-

sion and the use of certain property shall continue in the mortgagor (the railroad company) until it defaults.

A mortgage is then a pledge in which the possession does not pass to the mortgagee; it is a dead pledge. The literal meaning of the word "mortgage" is "dead pledge." The word is derived from the French words "*mort*" (dead) and "*gage*" (pledge).

That the mortgaged property shall not lose its value, the railroad company agrees in the mortgage to keep the property in good repair, and as part of the operating expenses of the road to make all necessary and proper improvements and betterments.

It is quite often provided that when a certain proportion (usually about one-third) of the holders of the outstanding bonds shall request the trustee to demand of the railroad company, that the railroad company shall thereupon supply a report from its chief engineer as to the physical condition of its property and equipment; or, if the trustee so elects, he may have such property and equipment examined by an engineer of his own selection. Should the mortgaged property and equipment upon such examination be shown not to be in good repair and condition, then the railroad company shall within a specified time (usually ninety days), put the same in a proper condition. Failure to do so, it is usually provided, is such a breach of the mortgage as will en-

title the trustee to enter into possession of the property and sell the same, or to foreclose the mortgage. If the railroad company were merely permitted to use the property as it was at the time of the giving of the mortgage, even though kept in good repair, it would soon deteriorate unless replaced by new parts or improved along the lines of the most recent development for efficient operation. The railroad company is therefore permitted, upon the consent of the trustee, to sell, alter, or remove any building, fixtures, machinery, or appliances, which cannot be advantageously used in the judicious operation and management of the road, upon condition that it shall replace the property so sold or removed with other property of equal value and which shall immediately become subject to the mortgage; or that the railroad company shall pay to the trustee the appraised value of such property. The trustee holds such money so paid him for the security of the bondholders until it is used to replace such property; or the mortgage may provide that the trustee shall purchase with such money bonds secured by the mortgage, and that thereupon these bonds so purchased shall be canceled, the mortgage debt thus being reduced correspondingly to the reduction of the security.

When stocks, bonds, or other securities are deposited with the trustee under the mortgage, it is usually provided that should they fall below the

value at which they were accepted as security under the mortgage, the trustee shall demand, and upon such demand the railroad company shall replace them by others, or that it shall deposit additional securities to keep the aggregate amount of deposited securities at the value at which they were originally accepted.

(h) Insurance against loss by fire, etc.

To secure such of the mortgaged property from loss as is liable to be injured or destroyed by fire, the railroad company agrees, in the mortgage, that it will insure such property in a solvent fire insurance company to be approved by the trustees. In case of loss, payment of the insurance money is made to the trustee.

The trustee holds such insurance money as a substitute for the property that has been destroyed or damaged. But property necessary for the successful operation of the road cannot be dispensed with. Insurance money in the hands of the trustee held at the expense of property necessary to maintain the road interferes with the productivity of the road. Railroad mortgages, therefore, quite generally provide that the damaged or destroyed property, when feasible, shall be repaired or replaced with the insurance money. The railroad company accordingly proceeds to repair, reconstruct or replace the property injured or destroyed. As

this work progresses, the trustee pays over to the railroad company, from time to time, out of such insurance money, sums equal to that expended by the railroad company in such work, when such expenditures represent the actual value of the work.

(i) Description of the mortgaged property.

The mortgage must specifically mention the property it pledges as security. The lien of the mortgage does not attach to any property that is not included within its terms.

The usual railroad mortgage conveys the land, rolling stock, property, franchises, rights of way, all appurtenances, buildings, structures and improvements of the railroad company. And when stocks, bonds, or other forms of securities are included they are set forth in a detailed list. The mortgage may also contain the "after acquired property" clause, by which it is intended to include in the mortgage such property as the railroad company may acquire at any future time during the life of the mortgage.

The income of the road is not included in a mortgage by implication; to include it it must be specifically mentioned.

Should income be included in a mortgage, the railroad company is entitled to all its income while in control and operation of the road. It is entitled to these moneys, notwithstanding that they are included in the mortgage, until it defaults under some

of the terms of the mortgage and the receiver takes possession under order of the court or the trustee demands possession under the mortgage. This is the law in the absence of any agreement to the contrary. The mortgage may, though it is unusual, contain a provision that the income, earnings, and profits received by the railroad company while it is in possession and operates the road, shall be considered as held by it in trust for the bondholders.

Any income included in a mortgage is held to mean net income; that is, the income after all expenses necessary to produce it have been deducted.

Income only is sometimes mortgaged for the payment of the interest only of an issue of bonds. This is in the case of income bonds, where the payment of the interest of the bonds is dependent upon the fact that the income has been earned during that interest period. See *Income bonds, etc.* Page 329. The mortgage by a railroad company of "all its right, title and interest" in the rolling stock and equipment used by it, as is sometimes done, suggests the inquiry as to what right, title and interest it has in such rolling stock or equipment; whether or not it owns it and what liens it is subject to; or if it is being used under a lease or car trust arrangement. See *Car trust certificates or bonds.* Page 316. Also see *Equipment trust certificates or bonds.* Page 316.

(j) After acquired property.

In addition to such property as is specifically named in the mortgage and which the railroad company owns at the time the mortgage is executed, there may be included also such property as the company might acquire at some future time during the life of the mortgage.

The lien of the mortgage attaches to such after acquired property whenever the railroad company acquires it.

The intention of the after acquired property clause in railroad mortgages is usually to impress the lien of the mortgages upon such property as may be substituted or added to equip the road with modern appliances as well as to replace worn out parts with new material.

This clause, however, may be construed to cover all property that the railroad company might acquire at any future time during the life of the mortgage, that is, property of a different nature and under different circumstances than just mentioned. How far reaching an effect the courts will give to this clause depends upon its language.

The lien of the after acquired property clause, under all circumstances, attaches to the after acquired property in the condition that it comes into the possession of the railroad company. If there are any mortgages or other liens against it at the

time the railroad company receives it, they take precedence and priority over the lien of the mortgage containing the after acquired property clause.

Railroad mortgages have the tendency not to include the after acquired property clause; at any rate not to have one that is so broad that it may embarrass, if not prevent, it from acquiring a branch line or an extension, or other property, when it was not really the intention that property of this kind should be included in the mortgage.

But this embarrassment is sought to be avoided, when property of the kind just mentioned is acquired and the after acquired property clause is broad enough to include it, by taking such property subject to as large a purchase money mortgage as possible; or by leasing instead of purchasing it; or, when the property is rolling stock, by taking it under the "car trust" arrangement; or, when it is a branch line or extension, by incorporating a separate company and taking the property in the name of such new corporation, organized for that purpose only. Rolling stock and equipment is also sometimes taken under this plan of a separate corporation holding the title to it.

(k) The railroad company agrees to preserve the lien of the mortgage.

The railroad company also agrees in its mortgage that it will pay all taxes, water rates, assessments,

and governmental charges lawfully imposed on the property.

Taxes, and charges of that character, are a lien against the property of the road superior and prior to all mortgages, no matter when they accrued.

The company, therefore, agrees to discharge all such claims, and also such other claims, the lien of which might be given a preference over the lien of the mortgage. Under this heading, and contemplated by such a provision, are claims for operating expenses and other indebtednesses entitled by law to a preference. See *Operating expenses prior to receivership*. Page 245.

The failure of the railroad company to discharge liens and claims of this nature would result in having the standing of the mortgage displaced in favor of such preferred liens and claims, and thus the priority that the bondholders enjoyed and were entitled to would be lost to them. The railroad company obligates itself, therefore, to pay all claims of this kind before they fall in arrears so that the standing and lien of the mortgage shall be preserved.

It is usually provided, however, that the railroad company shall not be required to pay such taxes, assessments, or other claims entitled to a preference over the mortgage, so long as it shall in good faith contest their validity. And a failure to pay such claims will not be construed as a default if the company is contesting them in good faith.

(1) Execution of all papers necessary to facilitate the trust; waiving redemption and exemption laws.

The railroad company always agrees in its mortgage that it will execute and deliver to the trustee any legal instruments or documents that may, after the mortgage is executed, be necessary to carry out the purposes of the trusteeship. This is to insure full power and title in the trustee to proceed in behalf of his bondholders in any matter that may arise under the mortgage.

Should the title as conveyed to the trustee by the mortgage be questioned at any time, the court will compel the railroad company to execute all legal instruments needed to vest in the trustee such title as may be necessary for him to fully protect the rights of his bondholders under the mortgage and to carry out his trusteeship.

And to further facilitate the trustee in pursuing his remedies, the railroad company usually agrees in its mortgage not to apply for or avail itself of any appraisement, valuation, stay, extension, exemption or redemption laws that may prevent or interfere with the entry of the trustee into possession and his operation of the road or his proceeding to foreclose the mortgage, and expressly waives the benefits of such laws.

And as a further aid in the enforcement of the security afforded by the mortgage, the railroad com-

pany consents, so far as it can, to the appointment of a receiver, when the trustee applies to the court for a receivership. And it further consents, usually, that the trustee shall receive the income of the mortgaged premises and property during such legal proceedings.

(m) Rights, remedies, powers and liabilities of the trustee, etc.; trustee's certificate.

Throughout the railroad mortgage, certain rights and remedies are conferred, and certain duties are imposed on the trustee in favor of the bondholders; and he is there given power to perform certain acts for their protection which the law does not ordinarily give him. Apart from what the bond or the mortgage may say in this respect, the law imposes on the trustee certain duties growing out of the trust relation that exists between him and the bondholders.

It is the duty of the trustee to protect his bondholders and realize on the security for them. Accordingly, he must proceed at once to enforce the remedies that the law and the mortgage give him to protect the rights of his bondholders. But the mortgage usually modifies immediate action by providing that the trustee shall proceed with regard to certain remedies only when requested to do so by the holders of a certain proportion of the bonds then outstanding, or that he need not proceed until he

has been properly indemnified against any loss he might sustain or liability he might incur in carrying out any of these special remedies in behalf of the bondholders.

To protect the holders of an issue of bonds against an over-issue, or a fraudulent issue, the mortgage provides that the trustee shall authenticate each bond of the issue with his certificate; any bond issued without such certificate is void and is not entitled to the benefits of the mortgage securing the issue. Such bond cannot be enforced. Should the trustee's certificate be forged the bond is void and not entitled to the benefits of the mortgage. For form of trustee's certificate see Page 75.

After he certifies them the trustee may put out the bonds himself; or he may return them, after certification, to the railroad company to be put out by it. He may put them out or turn them over to the railroad company, as the case may be, all at once, or in certain portions or allotments, at such times and in such quantities or amounts as the mortgage shall provide.

The rights and remedies of the trustee under the mortgage and under the law, with the duties and obligations growing out of his trusteeship, due to the very nature of that relationship, are more fully discussed in the next chapter. See Chapter IV. *Rights and Remedies with Relation to the Trusteeship.* Page 116.

(n) Provisions as to payment of principal and interest; free from all taxes; gold coin.

The railroad company agrees in the bond and the mortgage to pay each instalment of interest, and the principal of the bond, and each instalment of principal, when they respectively fall due.

It also usually agrees to pay these sums without reduction from principal or interest for any taxes, assessments and governmental charges that may be imposed upon the bond or the interest, which the company may be required to deduct therefrom. This provision includes payments under the income tax law. The holder of the bond or coupon, as the case may be, receives his interest in full without any deduction for the tax, the railroad company, being liable therefor, makes the payment to the government officials.

In the absence of any provision to the contrary, immediately upon the default of the railroad company in the payment of any instalment of interest, or of an instalment of principal, or the performance of any of its obligations under the mortgage, the railroad company is in default and the remedies that the trustee has at his command may be enforced against the mortgaged road and property. See *What constitutes a default.* Page 148. In the so-called "Gold Bonds" the issuing company agrees in its bond and mortgage to pay the bonds and interest or the coupons, in the case of coupon bonds,

in gold coin of the United States of America, of or equal to the standard of weight and fineness at the time of the issue. The holder may then insist upon such payment.

(o) Priorities, if any, between principal and interest; canceling paid coupons.

It is usually provided in railroad mortgages that they shall secure the payment of the principal and the interest of all the bonds issued under it, without preference or priority, and equally and ratably. However, a different arrangement may be made in distributing the proceeds of the mortgaged property, and interest may be preferred in payment over principal; or the different instalments of interest may be preferred in payment according to the dates on which they respectively fell due; or some other arrangement may be properly included in the mortgage. See also *Priorities between interest coupons and claims for interest.* Page 260.

Where there is nothing said in a mortgage about priority, all claims under it for principal and interest share proportionately.

Railroad mortgages usually provide that when the interest coupons are paid they shall be surrendered and canceled. Should paid coupons be allowed to remain uncanceled, there is danger that they may be negotiated again and their holder seek the protection of the security in conflict with the holders

of the unpaid coupons and the bonds. The coupons are either paid by the trustee or under his supervision; and he protects the bondholders by seeing that such paid coupons are canceled. The provision is also added in the mortgage that all coupons maturing before the delivery of the bonds shall be cut off and canceled before such bonds shall be put out.

(p) Sinking fund arrangement.

The sinking fund arrangements that are included in railroad mortgages vary according to the objects that are to be attained. The basic idea of all sinking funds plans is to set aside a specified sum periodically, annually or semi-annually, and with it to buy in the bonds of the issue at stated periods, and thus reduce the bonded indebtedness gradually; or to save up, as it were, to meet the entire issue at maturity, in the meantime investing the fund so accumulated.

The trustee owes the active duty to the bondholders to see that the railroad company faithfully carries out the sinking fund arrangement.

The details of the particular plan used are set forth in the mortgage.

A common method that railroad companies employ to create and maintain the sinking fund is that by which it agrees to turn over to the trustee at designated times (usually annually or semi-an-

nually) either a fixed sum; or a certain proportion of its gross earnings or net income, or other specified source of income or revenue; or an amount equal to a specified proportion of the amount of the outstanding bonds.

If the plan is to meet the entire issue at maturity, the trustee usually takes the money so received from the railroad company, and invests it in interest bearing securities. With the interest from these investments, the arrangement may provide that he shall pay the interest on the bonds, or, the provision may be that the railroad company shall pay the interest; or the plan may provide that the trustee shall reinvest such interest as he shall receive, from time to time, and accumulate the same which also shall be used to meet the bonds at maturity.

The trustee must watch the securities in which the sinking fund is invested, and when any depreciates appreciably in value, he must see that it is replaced.

The arrangement may be that by which bonds of the issue are called in periodically, the trustee then buys them up with the moneys so received for that purpose; and after purchase usually holds them as against the railroad company as if they had not been paid off. The bonds thus purchased and held by the trustee continue to draw interest; this interest is received by the trustee and used by him to buy in more bonds for the sinking fund. The mortgage

continues to secure such bonds so purchased and held by the trustee.

A failure on the part of the railroad company to maintain the sinking fund according to the terms of the mortgage is a default and entitles the trustee to enforce the mortgage. A provision may be contained in the mortgage, and it usually is, that a default of this kind shall continue for six months before action shall be taken on it.

When the sinking fund arrangement or plan is that a specified proportion of the bonds shall be paid off at designated periods, until the entire issue has been gradually retired, the question presents itself: Which bonds shall be paid off? The course usually pursued, and the plan that most railroad mortgages contain, is that the trustee shall buy the specified number or proportion of the bonds in the open market at a price not to exceed that fixed in the mortgage; but before buying in the open market the trustee must, under the terms of such plan, give the bondholders of that issue a reasonable opportunity to first offer their bonds to him. He notifies the bondholders by advertisement in the newspapers, that he has received a certain sum for the sinking fund to purchase the bonds at a price not to exceed the price mentioned in the mortgage and invites them to present their bids on or before a designated date. Such bid must specify the price at which

the holder will sell. The trustee reserves the right to reject any part of the offer should more be tendered than there is money.

When the bids are opened, the bonds offered at the lowest price are accepted and such bonds are paid off and held by the trustee under the terms of the sinking fund plan.

If the trustee cannot buy at the price the mortgage limits him to, neither in the open market nor through advertising, then he shall call in and pay off the necessary number or amount or proportion of bonds and pay them the amount or price stipulated in the mortgage. He calls them in by drawing by lot.

The manner of drawing is fixed in the mortgage. It usually takes place at the office of the trustee; though another place may be designated.

Bondholders are entitled to receive notice of what bonds have been called in for the sinking fund. Such notice is usually given by the trustee at the expense of the railroad company, by advertising in newspapers of general circulation in a city of recognized importance as a money center. Such notice is also published in newspapers in the city where the railroad company has its principal office.

The notice is usually published once a week for a few consecutive weeks. It states the numbers of the bonds that have been drawn for the sinking fund and retirement, and thus identifies them. If any of

the drawn bonds be registered, the registered owner is entitled to a similar notice to be mailed to his address as given on the registry books, within a reasonable time prior to the date fixed for its retirement.

The effect of having a bond drawn for the sinking fund is that the holder of such bond must surrender it, with all coupons maturing after that date, to the trustee for purchase by him at the price agreed upon in the mortgage. Should the bonds be registered they must be surrendered with a proper assignment in writing.

The bonds are called in on an interest day as an invariable rule. And the holder upon surrender receives the price agreed upon plus the interest to that date.

Should the holder not surrender his bond when drawn for the sinking fund, whether wilfully or through lack of notice or knowledge, he loses his right to interest from the date specified for its retirement. The bond will not bear interest after that date and all coupons for future interest are void. The bond itself, however, continues, so far as its principal is concerned, as a valid obligation of the issuing company and it is not affected by the fact that it was drawn for the sinking fund; except that sometimes it is stipulated in the mortgage that the bond so drawn for the sinking fund and not surrendered shall no longer be entitled to the benefit of

the security of the mortgage and its sinking fund after the date it should have been surrendered.

The sinking fund arrangement by which the bonds may be regarded as additionally secured does not preclude the trustee or the bondholders from their other remedies, nor interfere with their other rights and remedies in any way.

The wisdom of the sinking fund which takes periodically from the working capital of a railroad large sums has been questioned. The sinking fund, however, is absolutely needed to meet the bonds of corporations working mines, timber lands, or other enterprises in which the assets are being constantly depleted. The property of a railroad company in good standing is, as a rule, being constantly improved and in the course of time should afford a better security.

(q) Redeeming bonds or calling bonds in.

Sometimes the railroad company has the right, under the terms of its mortgage, to call in and pay off all or any portion of the outstanding issue at its own option.

The period within which it may do so is then specified. Bonds that are payable "30–50" years typify this. In such an issue the bonds may be called in at any time from after thirty years from the date of issue to the time of maturity. The price

that must be paid on calling in the bond is fixed in the mortgage.

The holders of the bonds are entitled to a reasonable notice of the intention of the railroad company to exercise this option to redeem, to call in, or to pay off their bonds. The mortgage sets out in detail all the requirements of the notice and how and when it shall be served. Usually one to six months' notice is given by advertisements in the newspapers. The notice advises the bondholders that the railroad company has elected to and will redeem certain outstanding bonds, describing them, on a specified date, at the price agreed upon in the mortgage, with accrued interest.

The bonds are usually to be presented and paid off at the office of the trustee, though another place may be designated. After the date fixed for such redeeming, they will cease to draw interest and the coupons for interest accruing subsequent to that date will be void.

It is sometimes stipulated in the mortgage that after the date fixed for their redemption, the bonds shall cease to be entitled to the protection of the security of the mortgage. Though the security of the bonds may be thus taken from them by agreement, they continue as valid obligations of the issuing company, which continues liable for the principal though the interest thereon may be lost from the date fixed

for redemption. Payment or accepting other securities in their place, or some other kind of satisfaction alone can discharge them.

However, if the bonds and their coupons are properly presented at the time and at the place fixed for their redemption and payment, and they are not paid according to the terms of the mortgage, then the interest and the coupons continue as theretofore, and the bonds and their interest continue to be secured and protected by the mortgage.

(r) Payment of serial bonds; bonds issued in series.

The uncertainty as to when a railroad bond may be called in for sinking fund purposes, or redeemed by the railroad company, with possible loss of interest and security, has been considered an objection. To overcome this the serial bond is employed. These bonds are like other bonds except that they are numbered consecutively, or divided into classes designated by letters. At a fixed time the bonds of the issue of a specified lettered class, or those within certain numbers, fall due and are paid. The price that shall be paid for them is fixed in the mortgage. Under this arrangement the holder has the advantage of knowing just when his bond will mature.

Serial bonds, just discussed, are to be distinguished from bonds issued in series. A mortgage may secure an issue of bonds in an aggregate limited amount,

and provide that they shall be put out in series of specified amounts, from time to time, at fixed periods, or as the needs of the railroad company shall require, or upon the happening of a certain event, or upon some mentioned condition, as the case may be. All bonds of such an issue fall due upon the same day no matter when issued or put out. They are merely put out and sold in series. This is the practice in the case of a large issue, usually under a general mortgage or blanket mortgage. The proceeds of a series, or part of such an issue, is used usually to retire underlying liens and so to clear the way to strengthen the lien of the general or blanket mortgage; the proceeds of another series may be used to provide for present needs of the road; and the balance furnishes the ready means to raise money in the future, without the trouble and expense, and possible adverse market conditions, of other issues at each time such money may be required. The entire issue is secured by the mortgage.

(s) Refunding plans.

The refunding mortgage will contain the plan whereby part of the money to be raised (though the entire amount of the issue may be devoted to that purpose) shall be used to take up some prior issue of bonds or notes, secured by a prior or underlying lien.

Railroad bonds are not paid off at their maturity,

as a rule, in the sense that the obligation is discharged and no other takes its place. It is the practise to take up an issue of bonds or notes when due with bonds or notes of a new issue. The old issue is retired by being exchanged for the bonds of the new issue or by being paid off with the proceeds of such new issue.

The bonds of such new issue are the refunding bonds, as they refund the old issue and so succeed, under their mortgage, to the lien that the latter had on the property of the issuing company.

Consolidated companies use refunding issues to refund or meet the bonds issued by their constituent companies before consolidation, and secure them by a mortgage upon the entire system.

The custom seems to be to make the refunding issue for a larger sum than the amount of the bonds to be met and retired. The excess is then used, quite generally, to meet present requirements of the road, for new construction contemplated, or to pay for additional equipment, or to provide money for future needs.

The plan by which the refunding is accomplished is set forth in the mortgage in detail. Different methods may be employed. The one most common and most generally adopted is that by which the old bonds are retired in such a manner as to gradually substitute the refunding bonds in their place so that finally the lien of the mortgage securing the old bonds

is discharged and the lien of the mortgage securing the refunding bonds takes its place.

Under this plan of refunding, which is the usual one, the old bonds are presented by their holders, at maturity, for payment, to the trustee of the new refunding mortgage, and are paid out of the proceeds of that new issue. Or the bonds of the issue to be retired are surrendered to the trustee for exchange for bonds of the refunding issue, when that is the agreement.

These bonds of the old issue, whether the trustee received them by exchange for bonds of the new issue or paid for them with the proceeds of such new bonds, he holds uncanceled; and the mortgage that secured these old bonds continues in effect, and continues to secure them thus in the possession of the trustee.

The trustee stamps upon the face of such bonds thus refunded that they are payable only to him as trustee; and thereafter he holds these bonds in trust uncanceled. They are thus continued alive so far as the railroad company is concerned so that they, in the hands of the trustee, shall be secured by their original underlying mortgage and entitled to all its benefits. And the trustee as the holder in trust of these refunded bonds has the same rights under that original underlying mortgage, as any bondholder under it had.

The trustee holds these bonds he has thus refunded

for the protection of all the bondholders of the new issue. In this way the old issue is refunded bond for bond, and each new bond that refunds the old bond takes the rights of the latter, in effect, under the underlying mortgage. By this method of gradual substitution the entire issue of old bonds is met, refunded, and disposed of. Then the mortgage that secured them is canceled of record and removed, and the lien of the mortgage that secures the new issue succeeds to its place. There then is no longer need that the old bonds be continued alive to protect the new ones (so that they might claim, as was seen, the protection of the old mortgage), so they are destroyed by the trustee.

Provision is also made in the mortgage that the old bonds held by the trustee during the progress of the refunding, shall not draw interest, but that the payment of the interest on the new refunding bonds shall be a payment of interest on the old bonds so held, until default in the payment of such interest, whereupon all the rights that the original holders of the old refunded bonds had, may then be enforced by the trustee, who holds them for that purpose. These rights that he thus gets and enforces are for the benefit of all the holders of the bonds of the refunding issue.

At the time of the issue of the refunding bonds all of the old issue may not have matured. Provision is then made for this by reserving sufficient refund-

ing bonds to meet these old bonds as they fall due. However, the holders of the old bonds may consent to surrender them before maturity and exchange them for bonds of the refunding issue. Should any object to the retirement of his bonds before maturity, then the trustee puts aside bonds of the refunding issue to meet those of the old issue as they fall due, either by payment with their proceeds or by exchange for the bonds themselves. The holders of the old issue are entitled to be paid in cash and cannot be compelled to accept bonds of the new issue unless they agreed to this in some way.

(t) Provisions for converting the bonds into the capital stock of the railroad company.

The option or privilege is contained in some railroad bonds or mortgages, by which the holder may convert his bond into the capital stock of the issuing company, or for such other securities as may be agreed upon.

This right to convert is an incident of the bond and passes with it from holder to holder and may be exercised by whomsoever is the holder at the time when the stock may be demanded. This right may not be assigned separately from the bond.

When the bondholder exercises this option or privilege and exchanges his bond for stock of the railroad company, he is no longer a bondholder and creditor of the company, but he becomes a stock-

holder and therefore a member of the debtor company. As such he has privileges which as a bondholder he did not possess, such as receiving dividends, voting, and having a voice in the selection of the corporate officers by whom the affairs of the company shall be managed. In the distribution of the assets of an insolvent road, as a stockholder he is entitled to his proportionate share of such assets after all the debts of the railroad company have been paid in full. The bondholders of the corporation, like other creditors, are entitled to be paid in full before the stockholders receive anything.

To become a stockholder, the stock must have been actually issued to him. That he demanded it and was legally entitled to receive it does not make him a stockholder. The stock must have been actually issued to him.

To exercise this option or privilege the bondholder must surrender his bond in proper form to the railroad company and make a demand for the securities strictly upon the terms set forth in the option.

The time when and the price, value, or ratio, at which the conversion shall be made are mentioned in the mortgage.

Time requirements must be strictly observed. And where the conversion must be made on or before maturity, or on or before any designated day, the holder must present his bond and demand his stock on or before the time specified else he loses his rights

under his option. The courts hold that under the circumstances, the railroad company is entitled to know on or before the maturity of the bonds, or on or before such other day as may be specified for the conversion, whether the holder elects to take stock or money, so that the stock which is not taken may be sold and the proceeds applied to the payment, in money, of the bonds.

Should no time be specified within which the holder may convert his bond, then the option must be exercised within a reasonable time. What constitutes a reasonable time depends upon the facts and circumstances of each particular case.

The demand for the conversion must be made at a reasonable hour on or before the day upon which the option expires.

When the option to convert is lost it is gone forever. The law holds that to extend the time, or, if already expired, to renew it, a new agreement is necessary. An extension of the time for the payment of the bonds, when the option to convert expired at maturity, does not of itself extend the time for conversion to the new date of maturity. A new special agreement is necessary.

The consolidation of the issuing railroad company with another, or with others, cannot defeat the right of the bondholder to convert. The terms of the statute or the agreement under which the consolidation is effected cannot be forced upon him summarily.

He is not permitted, however, to interfere with the consolidation. He is entitled to a reasonable notice of the intended consolidation and a fair opportunity to exercise his rights and demand stock of the company that issued his bond before it consolidates. Should he not demand his stock within the reasonable time that must be allowed him; or, should he by word or act participate in the consolidation (by which the issuing company loses its legal identity and power to issue stock), he will not be heard later to complain, and any rights he may have had to convert his bond into the stock of the issuing company up to the time of the consolidation, will cease with such consolidation.

However, the rights of the holders of bonds with the option of conversion are quite generally provided for in the arrangement for consolidation, whether by statute or agreement. As a general rule the consolidated company assumes or has imposed upon it all the liabilities of its constituent companies, including this one of conversion; and the consolidated company will issue its own stock to meet the demands of the holders of this option against the roads thus consolidated or merged.

Should the railroad company upon proper demand refuse to deliver the stock, the holder of the convertible bond had his election of two remedies. He may sue the issuing company for money damages for breach of this agreement; or he may compel the de-

livery of the stock, when that is possible. In the first action, the measure of damages is the market value of the stock at the time it was refused, less the value of the bond. If the bonds are to be taken up at their maturity with stock, then the measure of damages is the market value of the stock at that time, less the value of the bond at that time. The suing bondholder in each instance retains his bond, hence the deduction of its value in each case. Should he turn over his bond, or be ordered to do so by the court, its value then is considered in arriving at the amount of his damages.

In the action to compel the delivery of the stock it is no answer for the railroad company to say that it had none of its stock ready and that it cannot acquire any except at ruinous prices upon the market. It should have provided against such a contingency. And where it is an impossibility to procure the stock, even at a loss to the issuing company, it must answer in money damages and pay the value of the stock at the time it should have been delivered.

The relative price, value, or ratio at which the bonds shall be exchanged for stock is fixed in the mortgage. This is the conversion parity. When the convertible bond and the stock for which it may be exchanged are quoted at the price, value, or ratio fixed in the mortgage, the conversion parity is said to be maintained. The holder of the convertible bond seeking gain by the conversion, of course, watches for

the time when the conversion is in his favor, and if it be during the period within which he may convert, he then exercises his option.

(u) Re-possession by the railroad after receivership or possession by the trustee.

The default of the railroad company in the payment of interest or principal of the bonds may have been caused by conditions that were temporary only; and after the receiver or the trustee has taken possession, it may be able to retrieve its lost standing. It may then be in a position to pay all that is due under the mortgage. It is but just that it should be given this opportunity to do so, and it is usually to the advantage of the bondholders that it should pay up and retake possession of the road and resume operation, as it thereby prevents the sacrifice that usually attends a forced sale of property and the resultant loss to the bondholders and other creditors.

Railroad mortgages accordingly contain, without exception, a provision that at such a time the railroad company by paying all that is due under the mortgage and the expenses that have been incurred, shall be entitled to the re-possession of the road as if no default had taken place.

It is usually provided that the railroad company shall exercise this right at any time up to the actual sale of the property at foreclosure.

And should the railroad company be restored to

possession under these circumstances and resume the operation of the road, it shall not affect the rights of the trustee or the bondholders to again take possession of the mortgaged property or to foreclose the mortgage and ask for a receiver upon a subsequent default.

(v) Remedies to enforce the mortgage.

Immediately upon the failure of the railroad company to pay an instalment of interest, or the principal, or an instalment of principal, or to perform any of the obligations of the mortgage, the rights and remedies of the trustee in behalf of the bondholders to realize on the security may be enforced, in the absence of any provision to the contrary. To guard against the harm that will result in disrupting a road by a foreclosure, or the taking of possession by the trustee, when the company may be only temporarily embarrassed, the usual railroad mortgage provides that the rights and remedies to realize on the security shall be enforced only when the non-payment of interest shall have continued for a specified period, usually three or six months.

The principal of the bonds must be paid when due and no provision for a period of grace is contained in the mortgage as in the case of interest; the same rule quite generally applies to the payment of an instalment of principal. However, the remedies to enforce the security with relation to failure to pay

principal, or an instalment of principal, when due, or with relation to other defaults under the mortgage, may be postponed by the mortgage; the time of grace in each instance is mentioned.

The trustee has no power to waive any default by the railroad company without the consent of the bondholders, unless the mortgage gives him that power.

It is sometimes provided in the mortgage that the trustee must, upon the application of the holders of a certain proportion of the outstanding bonds, foreclose the mortgage, or pursue any of the other remedies that the mortgage may give him, as they shall elect; and that he may act with respect to these remedies only when empowered by the holders of the requisite proportion of bonds. Should there be no limitation upon the action of the trustee, then he may use his own judgment.

The remedy that the law gives upon default by the railroad company, independent of any that the mortgage may contain, is the right to foreclose the mortgage and ask for the appointment of a receiver to take possession of the road and operate it during the foreclosure proceedings. The receiver then holds the road until a sale is had or a reorganization of the company is perfected.

The railroad consents, so far as it can, to the appointment of a receiver upon the application of the trustee; and it agrees in its mortgage that with rela-

tion to legal proceedings instituted by others than the trustee, it will not suffer or voluntarily permit a receiver to be appointed of its property unless with the consent of the trustee.

In addition to the right of foreclosure which the law gives independently of any provision in the mortgage, the usual form of railroad mortgage confers on the trustee the power to sell the mortgaged property with or without entering into possession. Should he take possession of the road under such power granted him by the mortgage, he is usually permitted by the mortgage to operate the road until all the claims under his mortgage are satisfied and paid or adequately provided for.

In granting this power to sell, or to operate and to sell, the mortgage usually makes its exercise dependent upon the will of the holders of a certain proportion of the bonds then outstanding; and that the trustee shall only exercise such powers when the holders of the designated proportion of the outstanding bonds shall request it. The minority are bound by the act of the specified majority, when the mortgage contains such provision.

The sale by the trustee under this power, is at public auction after due advertising and notice. The time and place of such sale and the kind and amount of advertising and notice is specified in the mortgage.

As this power to the trustee to operate and to sell

is the result of an agreement of the parties, that same agreement, the mortgage, specifies how he shall distribute the proceeds of his operation of the road and its sale. It is usually to the effect that he shall first pay the charges and expenses of the sale and of the trusteeship; and then if the property be sold subject to prior liens, that he apply the balance to the payment of the bonds and interest under the mortgage. Should the property be sold free and clear of all prior liens, then before he pays the bondholders under his mortgage he must first pay those liens entitled to priority over his mortgage. Besides those liens entitled to priority over his mortgage, he must pay in full all unpaid taxes, assessments and governmental charges before he pays his bondholders anything. The holders of the outstanding bonds under the mortgage are usually paid without preference to whether the principal of their bonds is due or yet to become due. Claims for principal and interest usually stand on an equal footing; neither has preference over the other, though the mortgage may provide for priorities among the bonds and the coupons. See *Priorities, if any, between principal and interest.* Page 92. Also see *Priorities among interest coupons and claims for interest.* Page 260.

Should the fund realized by the trustee be insufficient to pay all the bonds and the interest coupons in full, when they all stand on an equal footing, they share proportionately. Should the mortgage provide

for any preference or priority among the bonds and the coupons, they are paid according to the order of preference thus arranged. Among classes of creditors entitled to liens or other priorities, each class is paid in full before those of the class next in rank receive anything.

CHAPTER IV

RIGHTS AND REMEDIES WITH RELATION TO THE TRUSTEESHIP

Relation between bondholders, noteholders and trustee generally.

The rights and remedies of the bondholders under their mortgage, broadly speaking, are held and enforced for their benefit by the trustee. The trustee represents the bondholders. The mortgage, or deed of trust, as it is sometimes called, is made to the trustee, he is the party to it and not the bondholders; it is to him that the property is conveyed as security; the remedies to realize on the security are enforced primarily by him; he sees that the railroad company performs all it is obliged to under the mortgage, among other things, that the property pledged by the mortgage is properly cared for and conserved by it, that it is properly applying its income to the payment of interest or principal of the bonds when due, and that these moneys are not diverted to other purposes; and it is the duty of the trustee to bring lawsuits or to defend them to enforce or guard the interests of his bondholders.

While the railroad company is paying interest on

the bonds as it accrues and doing all that it should do under the mortgage, the duties of the trustee are merely passive. When there is a default by the railroad company, his duties become at once active and decisive. He must take then such immediate steps as will best protect and serve the interests of his bondholders. The remedies that the trustee usually pursues are discussed in the next chapter. See *Chapter V. Rights and Remedies with relation to Foreclosing the Mortgage or Otherwise Realizing on the Security.* Page 146.

Reasons for trusteeship.

Railroad mortgages are made usually to secure an issue of bonds for large sums, offered for sale in the money markets of nearly every civilized country of the world, and held in time by persons scattered by residence or travel over the universe. It must be apparent how impracticable it would be to have each bondholder a party to the mortgage that secured his bonds. Then every transfer of a bond would require the transfer of a corresponding interest in the mortgage. This would destroy that capacity of railroad bonds for quick and ready transfer, and deprive them of that negotiability that the law, whenever it can, endeavors to give them.

By reason of frequent transfers, the holders of an issue constantly change. And if every bondholder were a party to the mortgage, originally or by reason

of assignment, then all would be necessary parties to any suit upon the mortgage; and to have this large and everchanging number unite in a lawsuit would seriously interfere with, if not entirely prevent, the enforcing of the security. It is necessary, therefore, that one or several representatives shall be chosen to act for all.

Who are chosen as trustees.

Individuals are sometimes chosen as trustees of railroad mortgages. The tendency, however, is to name a trust company. The combination of an individual, or a committee of individuals, with a trust company is sometimes employed. It seems that trust companies are chosen because they are better equipped than individuals to act as trustees of railroad mortgages. Many trust companies make a specialty of trusteeship of this kind, and maintain departments conducted by men experienced and skilled in the peculiar nature of the work. Furthermore, their financial resources, as a rule, are greater than those of individuals.

Courts hold trustees strictly to their duties.

Because of the delicacy of the relation that exists between a trustee and his bondholders, the courts zealously guard the interests of the latter and hold the trustees to strict accountability. The law demands that his conduct be characterized always by

loyalty to the interests that are entrusted to him. He must act with care and prudence and always in good faith.

Liability of trustee to his bondholders; limitation of liability; acts of representatives; losing rights against trustee; liability of trustee to third persons; indemnity to trustee.

The trustee must answer to his bondholders for any loss they may suffer through his misconduct in office or failure to faithfully discharge his duties. Railroad mortgages usually limit the liability of their trustees in some particulars. Bondholders by accepting their bonds consent to such limitations of liability contained in the mortgage. The usual limitation is that the trustee shall be liable to the bondholders only for his own wilful default or misconduct. The trustee is held responsible usually only for reasonable diligence in the management of the trusteeship. He is not held answerable to his bondholders for the wrongful act, or default, or failure to act, of any agent or representative, unless he did not use reasonable care in the selection of such representative. If he used reasonable care in selecting his employees or representatives, he is not liable to his bondholders for any loss sustained by their wrongful act or failure to act.

Bondholders may lose their rights to recover damages or for other relief against the trustee, should they

have consented by word or conduct to the act complained of, or in any way participated in it. Such consent may have been given prior to the act complained of, or it may consist of a subsequent ratification or acceptance of the unauthorized act of the trustee. Those bondholders who have thus countenanced improper official acts will not be heard to complain against that which, in law, they have consented to.

As to third persons, the trustee is liable personally to them, while operating the road, for any injury to their persons or their property, committed by his representatives or by himself. But it is invariably arranged in railroad mortgages that the trustee shall not personally pay such losses, but that they shall be borne by the trust property, and the trust property is accordingly charged with a first lien in favor of the trustee for his security and indemnification against such liability. A third person continues, notwithstanding such an arrangement, entitled to receive his damages from the trustee; the provision is for the reimbursement of the trustee and does not affect the rights of such third persons who are not parties to it.

Many railroad mortgages provide that the trustee shall not be obliged to take any action to carry out the trusteeship, which in his opinion shall be likely to involve him in expense or liability, unless he shall be first indemnified against such expense or liability by the bondholders in whose behalf he shall act.

Bondholders are bound by the official acts of the trustee.

In representing his bondholders, the trustee binds them by whatever he does officially in their behalf. The bondholders are thus bound by the acts of the trustee only when he acts strictly within the scope of his authority as their trustee. The bondholders will not be bound by the acts of the trustee when he is acting only for the railroad company, or in any matter outside of the mortgage, as in reorganization or other collateral transactions, unless he is specifically authorized by them.

Remedies of bondholders against their trustee; money damages; injunction; removal; compelling performance of acts.

Bondholders are entitled to sue the trustee personally and recover such damages in money, as shall compensate them for any loss they may have suffered as a result of his improper official acts. See *Liability of trustee to his bondholders; limitation of liability, etc.* Page 119.

They are also entitled to an injunction to restrain any act of the trustee that will waste or impair the property that may come into his possession under the mortgage. And when his acts imperil the safety of the property under his control, and his continuing in office is a menace to the interests of the bondholders, in addition to the injunction restraining him

from acting further, they are entitled to ask the court to remove him.

The court may compel the trustee to actually perform certain acts within his duties; accordingly, among other things, bondholders may compel their trustee to take possession of the road and operate it, when it is his duty under the mortgage to do so.

Co-trustees; majority; liability of co-trustees for acts of each other; succession by continuing trustee.

Where there are two or more trustees all must concur to give validity to an official act, unless the mortgage otherwise provides. Each trustee has an equal right in the execution of the trust and an equal power over the trust property. The decision of a majority has no force as a general proposition of law. Railroad mortgages, however, usually cover this contingency and quite generally provide that the vote of a majority of its trustees shall decide all questions before them. However, when a proper expenditure is made the consent of co-trustees is not necessary.

One trustee is not personally responsible to the bondholders for the misconduct of his co-trustee. Where, however, a trustee stands by and, without protest, permits his co-trustee to commit a fraud with relation to the trusteeship, and he does not take steps to protect his bondholders, the law declares that this shall be deemed an acquiescence in the wrong act,

though there be no actual participation, and renders him personally liable to them.

When there are two or more trustees and a part of that number is removed, or otherwise incapacitated from acting, the rights and powers that all had pass to the trustee or trustees remaining. The title to the property under the mortgage passes to the continuing trustee or trustees.

Trustee may not delegate to others the powers requiring his individual skill; details only may be delegated.

The trustee may not delegate to others the exercise of those powers which the bondholders are justified in assuming will be carried out by him. He may not relieve himself from performing those services that call for executive control and management of the trusteeship. With regard to such services personal attention is the basis of his duty.

One would not consent to have another act for him unless he had a certain confidence in the standing, talents, and general fitness of such person. His capacity for administration, his knowledge of the affairs of the railroad company are important factors that influence the appointment of a trustee. Bondholders are entitled to assume, therefore, that he will employ these qualities, talents and special knowledge for their benefit and will not delegate the performance of duties requiring this skill to others.

Matters of detail that do not call for skill of the nature discussed, may be performed by subordinates or representatives.

Personal interest of the trustee in the property forbidden when antagonistic to bondholders; purchase of trust property by trustee; remedies of bondholders; acceptance or rejection; waiving or losing remedies against trustee.

The law will permit no self-seeking by the trustee. There must be no fraud or collusion on his part. Every act of the trustee that will prejudice the interests of the bondholders will be condemned by the courts.

The trustee must not act for his personal advantage in dealing with the property that is the subject matter of his trusteeship.

There must be no clashing of his duty as trustee and his individual interests. Such a situation subjects the security to risk. Accordingly, the law forbids the trustee purchasing any part of the trust property for himself, without rendering himself liable to account to the bondholders therefor. But he may purchase on behalf of his bondholders at the foreclosure sale when authorized by them to do so. He then holds the property so purchased subject to the direction of the bondholders.

The law recognizes human infirmity and sees the

inevitable conflict between duty and self-interest. The vice, however, of the personal interest of the trustee merely taints his purchase of the trust property; it does not make such purchase absolutely void. That is, it is optional with the bondholders whether or not they will accept or reject a purchase or other dealing with the trust property by their trustee. Should it be beneficial to the bondholders, they may accept and enforce it; should it not be to their satisfaction they may ask the court to declare it void.

Until the bondholders by some act show their intention to avoid such purchase, or other personal dealing, by the trustee, it will continue in force. It is good until it is set aside. And the law will assume that the bondholders have accepted and confirmed the purchase, or other personal dealing, if they fail to object within a reasonable time. Their acquiescence will be inferred from their failure to object within a reasonable time.

Should the bondholders reject the transaction, then the trustee should be put, so far as can be done, in the position he occupied before his purchase or other personal dealing with the property. The bondholders may not cling to the proceeds of the transaction they seek to avoid; and the trustee should have returned to him, so far as under the circumstances it can be done, what he parted with when making the purchase complained of.

Litigation is conducted by the trustee; bondholders are then bound by decisions of the courts; appearance by bondholders; indemnity and demand by certain proportion of bondholders; when trustee loses right to litigate.

Litigation affecting the mortgaged property is carried on by the trustee in behalf of the bondholders. He represents them in all legal proceedings affecting the trusteeship.

Should a trustee act under several mortgages and should there be a contest for priority or preference between the different classes of bondholders under these several mortgages, the court will direct that each class be represented by a separate trustee who will be solely concerned in enforcing that one mortgage and getting for those whom he represents all they are entitled to.

Bondholders are bound by the decisions of the courts in legal proceedings in which they are represented by their trustee, with the same effect as if each bondholder were a party to the suit. And in all litigation affecting the trusteeship or the trust property, whatever legal steps the trustee is bound by, generally speaking, the bondholders are bound by. When the trustee acts fraudulently or outside the scope of his authority the bondholders are not bound by his acts.

Notwithstanding that the bondholders are represented by their trustee in all litigation, they are

entitled to appear before the court in all proceedings there pending, to ask it to protect their interests when necessary.

Railroad mortgages often provide that the trustee shall have the exclusive right to conduct all litigation under it, and that the bondholders shall not bring any legal proceedings under the mortgage, unless the trustee shall have failed to do so, after having been requested in writing by the holders of a certain proportion in amount of the bonds then outstanding. Some mortgages further provide that in addition to such request, there shall be tendered to the trustee a reasonable indemnity against his expenses and liability, before he shall be required to bring legal action. With such a provision in the mortgage, the trustee need not proceed with litigation until requested by the proper proportion of bondholders and, if indemnity be required, until such indemnity be tendered.

The trustee may lose his right to conduct the litigation of trusteeship. Then the courts permit bondholders to litigate in all matters necessary to protect their rights under the mortgage, instead of the trustee.

The trustee loses his right to litigate under the mortgage when he acts fraudulently or in collusion with others; or occupies such a position that his personal interests conflict with those of his bondholders; or his attitude is hostile to their welfare. Bondholders may also sue instead of the trustee when he improperly refuses or neglects to proceed.

If the mortgage provides that the trustee need not proceed with litigation until a demand to do so has been served on him by the holders of a specified amount or proportion of the outstanding bonds, or that he be first indemnified against any possible personal loss, then it must be shown that a proper demand or offer of indemnity has been made in accordance with the terms of the mortgage in that regard and the trustee notwithstanding has failed to proceed.

Bondholders may conduct litigation instead of trustee; one or more sues for all; all bound by decision of the courts.

When the trustee has lost his right to represent the bondholders before the court, by his fraud, neglect, or hostile attitude, one or more bondholders, instead of the trustee, may conduct the litigation of the trusteeship.

Those bondholders who thus conduct the litigation, do so on behalf of all bondholders secured by the same mortgage. This is on the rule of law that when a large body of persons have common rights and it is impracticable that all join and prosecute a lawsuit, one or more may litigate in behalf of all. Holders of a large issue of railroad bonds, many of whom reside or sojourn in different parts of the world, constitute such a body, and the law recognizes how impracticable it is to bring all together to unite

in a lawsuit; and, accordingly, the law will not allow this circumstance to unreasonably delay, if not defeat, their rights and remedies.

The same situation that makes it imperative that the bondholders act through a trustee necessitates that a very large body of bondholders be represented by one or a comparatively small number. Their interests are common. What affects one affects all. The action is brought by the few for the benefit of all. The decision of the court has in view and protects the rights of all, whether absent or present. And all are affected by the decision of the court, and bound by it, whether appearing personally in the litigation or not.

The court will not permit those bondholders who are active in the litigation to gain any advantage over the others. The rights of all are before the court and it protects the interests of all.

When one or more bondholders litigate instead of the trustee, then whatever rights and remedies the latter had to sue under the mortgage, pass to the litigating bondholder or bondholders, and are exercised by them for all.

Bondholders suing on individual holdings; recourse to security; provisions barring suits on individual holdings.

Each bondholder may sue the railroad company on his bond in his own behalf without restraint of any

kind, unless the mortgage contains a provision that bars his individual suit or regulates it in some way.

A bondholder, however, by his suit on his individual holding gains no advantage over the holders of the other bonds secured by the same mortgage, so far as the security under the mortgage is concerned; because, after obtaining his judgment, he is permitted only to satisfy it out of the property covered by the mortgage after the claims of the other bondholders have been satisfied in full, as the lien of his judgment, against that property, comes after the lien of the mortgage. He may satisfy his judgment, however, from other property belonging to the railroad company not covered by any lien, and also out of property against which prior liens exist after all such liens have been satisfied in full.

The right of a bondholder to bring individual suit on his bond is usually barred by a provision in the mortgage. This provision is usually to the effect that the rights and remedies of the bondholders under the mortgage shall be enforced only through the trustee. This is a waiver by the bondholder of his right to bring his individual suit in his own behalf.

Should the trustee by his wrongful act lose his right to represent the bondholders in litigation affecting the mortgage, it does not mean that the bondholder when barred by the mortgage may then sue on his individual holding.

Provisions in the mortgage barring bondholders from suing on their individual holdings do not affect the right, conferred by law, on one or more bondholders on behalf of all to institute or defend litigation affecting the mortgage when the trustee by improper conduct has lost the right to do so.

Selection of the trustee; general scope of his powers.

The selection of the trustee in the first instance is made by the railroad company. From this it should not be inferred that he is subject to its control or more friendly disposed towards it than towards the bondholders. See *Courts hold trustees strictly to their duties.* Page 118.

When the trustee accepts his office he assumes certain clearly defined duties to all parties interested in the mortgage and the mortgaged property. He can act with relation to the trusteeship and the mortgaged property only with such powers as the mortgage expressly or inferentially confers, or with which the bondholders may clothe him by collateral consent, or with which the law grants him independently of the mortgage.

The trustee has no power to waive a default by the railroad company in the payment of any money under the mortgage; nor has he power to relieve it from doing anything it is obliged to do under the mortgage; nor has he power to alter or modify any of

the terms of the mortgage. He has no powers to recognize subsequent and inferior liens and give them rank equal or superior to that of his mortgage. The trustee may only do those things just mentioned when the mortgage gives him that power or the bondholders specifically consent thereto.

Duties of the trustee generally; duties before default; duties after default; the remedies he pursues.

Railroad mortgages contain many provisions regulating the trusteeship and prescribing the duties of the trustee. His duties are governed largely by the terms of the mortgage, and any subsequent agreement to which he is a party. In addition to those duties thus imposed on him, by agreement, he is subject also to those duties that the law imposes on trustees who have undertaken a trusteeship involving the peculiar relations that exist between holders of railroad bonds and the trustee of railroad mortgages and which affect railroad property.

While the railroad company is paying interest and doing all it should under the mortgage, the duties of the trustee are merely nominal. They are limited to certifying the bonds of the issue, seeing that the interest is paid and keeping the property covered by the mortgage under observation so that it will not be wasted. When there is a default by the railroad company, his duties become active and he should take

immediate steps to protect the rights of his bondholders.

The trustee, generally, has at his command three remedies to pursue in behalf of his bondholders. One of these he adopts.

(1) He may take possession of the mortgaged property (which is usually the entire road or an entire branch or line) when the mortgage gives him that power, and operate it until the money due under his mortgage is either paid or adequately provided for; and, if necessary, he may sell the property he thus acquires, and satisfy the claims under the mortgage out of the proceeds. This is a remedy that he does not possess as a matter of law, he may only pursue this course when the mortgage gives him that power.

(2) Another remedy that the trustee does not possess unless the mortgage expressly gives it is the power to sell the mortgaged property at public auction, without entering into possession or operating it. This and the preceding remedy (where he does enter into possession and operate) are usually granted trustees by railroad mortgages.

(3) The third remedy and the one which the trustee usually adopts in preference to the others is that which the law gives him independently of the mortgage, that is, the right to foreclose the mortgage. Trustees invariably resort to this remedy as the operation of the railroad or its sale by a trustee imposes

upon him new responsibilities which, as a rule, they seek to avoid. Trustees, therefore, usually place the entire matter before the court for its action by foreclosing the mortgage. The court then, in a proper case, appoints a receiver, who, under its direction, takes possession and control of the mortgaged road and property and operates it until it is sold at the foreclosure sale or until the railroad company is reorganized and such property is taken over.

Discretion of the trustee in carrying out details of the trusteeship.

The trusteeship of a railroad mortgage involves many details. It would be impracticable for the trustee to seek the advice or permission of the court or the bondholders with relation to each detail. To cloak the trustee with a reasonable discretion in performing acts of this character is a necessity of the situation. And the bondholders by accepting him as their trustee, thereby expressing their faith and confidence in him, justify the law in permitting him to act according to his best judgment in carrying out such details. However, this discretion is not an arbitrary one. And no matter how wide a discretion may be given a trustee, it is subject always to review by the courts on the inquiry as to whether or not he has abused, violated, or over-reached, his discretion. It is difficult to state even the nature of those acts which the trustee may perform according to his dis-

cretion, and those to perform which he must first obtain permission of the court, the bondholders, or other interested parties. The decision of this question depends entirely upon the facts and surrounding circumstances of each case presented; and each case has its own particular facts.

Trustee seeking advice of court; advising with legal counsel; guided by opinion of bondholders; rights of majority; rights of minority.

In the course of the trusteeship under a railroad mortgage, situations may arise that are not provided for in the mortgage; or the trustee may be met with conditions upon which his duty is doubtful; or questions of unusual difficulty may present themselves. The trustee should then apply, as a general rule, to the court for its aid and direction.

Railroad mortgages may provide, and they usually do, that the trustee may advise with legal counsel, and the opinion of the latter shall be a full protection and justification to the trustee for his acts in good faith and in accordance with such opinion and advice.

The trustee may also seek the advice of the bondholders. The trustee is not justified in following the advice or will of the majority, no matter how large, unless the mortgage states that the voice of such majority shall prevail. The trustee must act for the bondholders as a class, and not for a majority of that

class. In some of the railroad mortgages it is provided that the will of the holders of a majority, or a majority of a specified proportion or amount, of the outstanding bonds under the mortgage, shall control with regard to those certain matters which are there clearly specified.

In such case the minority will not be heard to oppose what they have consented to. Each bondholder when he accepted his bond agreed to its terms and all the provisions and conditions of the mortgage accompanying it, and, in this particular, gave to the majority the power to speak for him. Should the mortgage not contain such provision, the majority do not have this power; it must be expressly granted by the mortgage in plain terms.

However, when the mortgage does not confer this power on the majority, it is not improper that the trustee be guided by the opinion of the majority, when what they advise is not inconsistent with the provisions of the mortgage and is urged in good faith. But the will of the majority cannot be forced under these circumstances upon the minority and, upon their objection, the court will examine into the proposed action of the trustee. If the proposed plan of the trustee be fraudulent or if it violates any of the rights of the minority, the court will prevent it by injunction; but, where the proposed action of the trustee under the advice of the majority is fair and does not violate any of the provisions of the mort-

gage, the court will permit the trustee to carry out such suggestions of the majority.

The action of the court in the situation just discussed is founded upon the peculiar relation that exists between the holders of bonds issued by a railroad corporation, a quasi-public corporation.

Removal of trustee; by bondholders; by court; for cause.

The trustee may be removed by the court for misconduct in office.

Should the trustee prove unsatisfactory or undesirable, railroad mortgages usually provide for his removal by the bondholders, though no reason may exist such as the court requires before it will remove a trustee. Such a provision is usually to the effect that the trustee shall be considered removed from office when the holders of a certain proportion of the outstanding bonds (usually more than a bare majority) shall file a writing, showing the amount of their respective holdings and their desire to remove the trustee. Thereupon he is removed from office and may not act further.

Where the mortgage makes no such provision for the removal of the trustee by the bondholders, or the requisite holdings do not unite under such a provision he may be removed by the court, but for cause only.

The cause for removing a trustee, generally speak-

ing, is a breach by him of some duty of his trusteeship. Such breach may be the doing of an act which he should not do, or failing to do something he should do.

The wrongful act or omission to act must be such as endangers the rights of the bondholders he represents or jeopardizes the security. Should his continuing in office be detrimental to the interests of the bondholders he may be removed.

The good faith of the trustee is often a matter that the courts consider upon an application for his removal. A mere error in judgment is not cause for his removal, unless it shows want of capacity or indicates dishonesty. In this relation railroad mortgages usually provide that the trustee may advise with legal counsel, whose opinion shall be a full protection and justification for the trustee for any act done in good faith and in accordance with such opinion.

The trustee may be removed for having a personal interest in the property, the subject matter of the trusteeship, antagonistic to that of his bondholders. The rigid rule that the trusteeship must be managed solely for the benefit of those in whose behalf it is undertaken is never relaxed.

Neglecting to give his personal attention to his duties is ground for removing a trustee. However, this relates only to the general executive control of the affairs of the trusteeship that calls for the skill

and capacity of the trustee, and not to matters of detail which may be performed by a subordinate or other representative. Foreign residence by a trustee, permanently and often temporarily, where it renders the full discharge of his duties doubtful, may be cause for his removal.

Any fraud or connivance on the part of the trustee subjects him to removal. He must act always in the highest faith and pursuant to his honest and disinterested judgment.

Resignation by trustee.

When the trustee accepts his office he assumes all its obligations and may not avoid its responsibilities by resigning or refusing to act unless with the consent of the railroad company and of the bondholders, or by order of the court.

Provisions for resignation by trustee; filling vacancies in the trusteeship.

Railroad mortgages, however, usually provide for the resignation by the trustee and for filling the vacancy thus created. When the mortgage does not provide for the resignation by the trustee and the appointment of a new one in his place, it may be done only on the consent of the bondholders and the other parties interested, or by order of the court. The court has the power to appoint a new trustee.

When the trustee is permitted by the mortgage

to resign, it is usually provided that he shall give notice of his intention to the bondholders and to the railroad company, by advertisements in the newspapers, and shall, if requested, execute and deliver to his successor any legal documents necessary to pass the trusteeship on. Ordinarily, such documents are not necessary, as it is usually provided in the mortgage that the new trustee upon taking office shall be possessed of all the rights of the former trustee, and that the latter shall become divested immediately of such rights upon his being separated from office.

The court will not allow a trusteeship to fail or to be neglected for want of a trustee or the misconduct of a trustee. This power of the court does not depend upon any provision of the mortgage; it is a power that is inherent in a court of equity.

Should the mortgage arrange for the appointment of a new trustee, the court will make the appointment thus agreed upon. The agreement of the parties in this regard will govern the appointment and not the general law.

The modes adopted by these agreements to fill vacancies in the trusteeship, whether contained in the mortgage or subsequently made, take various forms. Those most common, and of which one is followed, are that the new trustee shall be selected by the holders of a majority, or other proportion, in amount of the bonds then outstanding; or that the railroad company shall appoint the new trustee; or that a certain

court shall make the appointment; or where there are several trustees that those remaining, either unanimously or by a majority vote, as the case may be, shall name their new associate.

It is also provided sometimes that in the interval between when the vacancy occurs and the new trustee assumes office, the duties of the trusteeship shall be performed by one selected by the board of directors of the railroad company.

The qualifications that the new trustee shall possess are often specified. The usual requirements are that the new trustee shall be a trust company of good standing with a specified capital surplus and undivided profits and doing business in a certain city or state; or that he be a bondholder.

Compensation of the trustee; fixed by mortgage or agreement or by the court.

A reasonable compensation is paid to the trustee for his services in the execution of his trusteeship. His compensation may be fixed in the mortgage or by another agreement between all the parties in interest. When there is litigation and the affairs of the trusteeship are before the court, it then fixes the amount of the trustee's compensation.

The court in allowing compensation to trustees, as a rule, will take into consideration the actual work necessarily done. There is no fixed basis of compensation that the courts employ. The amount fixed

will be proportioned to the work that was necessary and actually rendered.

Bondholders are entitled to appear before the court and contest the amount which it allows the trustee if they believe it to be unreasonably large.

Expenses of the trusteeship; compensation and expenses paid by railroad company or out of the trust property; contribution by bondholders; expenditures for large or for limited amounts, or for certain purposes; lien of trustee for compensation and expenditures.

The trustee is reimbursed out of the trust property for his compensation and the necessary expenses of the trusteeship.

It is not necessary that the mortgage make any provision for the expenses of the trusteeship. It is a well settled rule of law that trust property shall bear the expenses of its care and administration.

The payment of the expenses of the trustee are usually provided for in the mortgage. The railroad company in its mortgage usually undertakes to pay the trustee for his services and reimburse him for all liability and expenses he may incur by reason of his trusteeship. Such an undertaking on the part of the railroad company is usually followed with the provision that should the railroad company not pay such monies, then the same shall be a lien on the property mentioned in the mortgage, and shall be paid out

of the proceeds of the mortgaged property before any payment therefrom to the bondholders. This latter provision for a lien, which the mortgage usually gives the trustee, is unnecessary because when the expenditures of the trustee have been proper, his claim for repayment and for compensation is a lien on the property in his charge, as a matter of law; and he is paid in full out of that property for his services, and for his expenditures, and for any liability he may have incurred in the course of his trusteeship, before the bondholders receive anything.

It is elementary in the law that if a large body of persons have an interest in a common fund or the same property, and one of that number takes proper and necessary proceedings to preserve that fund or property for their common good, he is reimbursed out of that property or fund for his services and all monies so expended by him; and if the fund or property prove insufficient then he shall be reimbursed by those who accept the benefits of his efforts and expenditures. The trustee of a railroad mortgage, under this principle, is entitled to be paid for his services and reimbursed for his expenditures out of the trust property; and if the trust property be insufficient, then by proportionate contribution from the bondholders in whose behalf or at whose request he acted.

The expenditures that a trustee is permitted to make are those necessary to preserve or repair the

property in his charge, including the reasonable fees for legal counsel to necessarily prosecute or defend litigation to protect the property.

If the expenses of a trustee are proper the approval of a co-trustee is not necessary.

Some railroad mortgages provide that before the trustee shall make expenditures beyond a certain amount or for a specified nature, he shall first obtain permission of the bondholders of a certain proportion in amount of the bonds then outstanding. Expenditures beyond the specified amount or of the designated character will not be allowed the trustees, when made without the required permission; but if the bondholders in the requisite amount subsequently approve these expenditures it will have the same force as if they had been authorized in the first instance.

The trustee will not be compelled to part with the property upon which he has his lien for services and expenditures until he has been reimbursed. This lien of the trustee, however, must not govern the situation so as to control the property and interfere with the working out of the trusteeship. The law will not allow the lien of the trustee to defeat the purposes of the trusteeship.

It was seen that the remedies that the trustee has at his command to realize on the security, upon default by the railroad company, are either to enter

into possession of the mortgaged road and to operate it, and, if necessary, to sell it; or to sell it without entering into possession; or to foreclose the mortgage and ask for the appointment of a receiver to operate the road until it is sold at foreclosure or the company is reorganized and the property thus taken over. These remedies are discussed in detail in the following chapter.

CHAPTER V

RIGHTS AND REMEDIES WITH RELATION TO FORECLOSING THE MORTGAGE OR OTHERWISE REALIZING ON THE SECURITY

Three usual remedies to realize on the security.

When the railroad company defaults under the mortgage, there are usually three remedies, one of which the trustee may pursue in behalf of the bondholders to realize on the security. He may take possession of the mortgaged property and operate the road and finally sell it, if necessary, when the mortgage gives him this authority; or he may sell the mortgaged road and property without taking possession, when that power is given him by the mortgage; or he may foreclose the mortgage and bring the entire matter into court. The right to foreclose the mortgage is one which the law gives and is independent of any provision in the mortgage; it is an absolute right and does not depend upon any grant of power to do so by the mortgage.

If there be no provision to the contrary, the trustee may choose and pursue that remedy which he believes will best serve the interests of the bondholders.

In many mortgages, however, it is left to the will of the holders of a certain proportion in amount of the outstanding bonds to decide which course the trustee shall pursue. These provisions are generally to the effect that the trustee shall only take possession of the mortgaged road and operate it, or sell it, when requested to do so by the holders of a specified proportion in amount of the outstanding bonds. In some mortgages there is a provision that the trustee need not proceed to take possession of the mortgaged road and operate it, even though requested by the requisite proportion of the bondholders, until they furnish him with indemnity against any loss he may suffer or liability he may incur while so operating the mortgaged road under the mortgage.

When the mortgage confers on the trustee the power to sell the mortgaged road, with or without taking possession and operating it, it does not preclude or limit the right to apply to the court for the foreclosure of the mortgage. The policy of the law is to aid the bondholders in obtaining payment of their bonds and interest and enforcing their security, and anything in a railroad mortgage that restricts the right to foreclose will be strictly construed; and whenever possible, the court will decide against any provision which tends to limit the right of the trustee or the bondholders to foreclose their mortgage.

When the right to commence proceedings accrues; what constitutes a default; in interest; in principal.

The right to enforce the security, which the mortgage or the law gives, accrues upon a default by the railroad company.

A default may be a failure to pay interest or principal, or an instalment of principal, in the manner required in the bond or the mortgage; or a failure on the part of the railroad company to perform any of the duties it has undertaken in the bond or the mortgage; or the doing of an act which it should not do and which subjects the mortgaged property to risk and jeopardizes the security.

The right to proceed to enforce the remedies is complete as a matter of law, immediately upon default by the railroad company; but railroad mortgages usually contain provisions with regard to defaults, either postponing the time when legal proceedings may be commenced thereon or making the action of the trustee to foreclosure, or otherwise proceed against the mortgaged property, dependent upon the wishes of the trustee or of holders of a specified proportion in amount of the outstanding bonds.

Reasons for provisions postponing action by trustee or holders.

The failure to pay interest, or principal, or an instalment of principal, on the day on which it is pay-

able is such a default, in the absence of anything in the mortgage to the contrary, as will entitle the trustee to commence immediately any of the proceedings he may have at his command, under the conditions previously discussed. But it is recognized that undue haste in this regard may cause an unnecessary sacrifice of property and bring about a disorganization of the railroad company to the injury of the bondholders and the others interested in its affairs. Railroad mortgages, therefore, quite generally provide that all proceedings by the trustee to realize on the mortgaged property shall be subject to certain conditions, or shall be postponed until the expiration of a certain period.

It may well happen that a road in its first years may not earn enough to pay its running expenses, its necessary repairs, and the interest on its bonds. A temporary financial depression, an unexpected falling off of revenue or of income, unusual expenditures, or extraneous circumstances may interfere with prompt payments even by an established road. Recognizing these possible conditions and in order to enable a railroad company, in good faith, to tide over a period of temporary embarrassment, railroad mortgages usually contain provisions regulating defaults in the payment of interest.

A provision of this character most common is that no action shall be taken by the trustee, or by the bondholders, to enforce the security for a default in

interest until the interest shall continue unpaid for a specified period after it is due and payable, usually three or six months. On short term obligations this period of grace is usually sixty days; and on obligations running for a year or so no provision of this kind is made. Another such provision is that the trustee shall proceed to enforce the mortgage only upon the request of the holders of a certain proportion in amount of the outstanding bonds.

Principal may fall due upon default in interest; when it does not; option of bondholders to declare principal due.

Upon default in payment of an instalment of interest the whole principal sum of the bond may fall due and be payable.

It is sometimes stated in railroad mortgages that when a default shall be suffered in the payment of an instalment of interest, and such default shall have continued for the specified period, usually three or six months, then the principal of all bonds secured by the mortgage and then outstanding shall become due and payable immediately.

When the interest has remained unpaid for the specified period and is in default the mortgage may provide that the trustee may declare due the principal of the bonds, if he deem it advisable; or the

mortgage may say that he must declare it due, leaving him no discretion in the matter; or the mortgage may direct that the trustee shall declare the principal due only upon receiving from the holders of a certain proportion in amount of the outstanding bonds a demand to that effect.

The usual provision is that the principal shall become due upon a default in interest, only when the holders of a specified proportion in amount of the then outstanding bonds shall declare it due. That is, it shall be optional with the bondholders whether or not the principal shall become due and payable upon such default in interest. Should the holders of the specified proportion, in amount usually a majority, of the bonds then outstanding desire that the principal shall so become due, they request the trustee to notify the railroad company that the principal of the bonds is declared due. Having consented to this provision in the mortgage by accepting their bonds under such mortgage, the minority are bound by the act of the majority in this regard.

If there be nothing said in the bond or the mortgage as to the principal falling due upon a failure to pay interest, nor should it be declared due, then the foreclosure, or other proceeding, as a rule, is limited to realize for the satisfaction of the defaulted interest only.

Default may be waived; rights of trustee and of majority bondholders to waive default.

A default by the railroad company in the payment of interest may be waived. Bondholders at certain times, and under some conditions, may deem it wise to defer legal action and, accordingly, may waive a default in the payment of an instalment of interest.

Railroad mortgages usually provide for waiving defaults. A fairly common provision is to the effect that the holders of a specified proportion, in amount, of the outstanding bonds secured by the mortgage, may waive the default by the company at any time before the property is sold.

When no legal proceedings have been begun, a waiver merely means that matters continue as theretofore; however, when legal proceedings have been instituted, then upon such waiver the railroad company is restored to all former rights and to possession of the mortgaged property, and all the rights, remedies, and powers of the trustee and the bondholders continue, as theretofore, as if no procedings to enforce the mortgage had been taken.

A waiver of one default, it is usually provided, shall not be understood as a waiver of any other or later default; nor shall it affect, in any way, the rights and remedies of the trustee or the bondholders with respect to enforcing the mortgage for any other or later default.

The trustee has no power to waive a default by

the railroad company unless the mortgage gives him that authority, or the bondholders by separate consent clothe him with this power; nor have a majority of the bondholders any power to waive a default unless the mortgage confers that right on them.

Redemption by railroad company and its repossession.

Upon default by the railroad company, should the trustee take possession of the road under authority contained in the mortgage, he is entitled to hold it until the amount then due is either paid or adequately provided for.

However, the usual form of railroad mortgage provides that while the trustee is in possession of the road, or foreclosure proceedings are in progress, the railroad company shall have the right at any time before the sale to have the mortgaged road restored to it upon payment of the amount due for principal and interest and of all costs, fees, expenses, and allowances. Should all not be then due, the court permits the railroad company to have repossession upon paying what is then due and adequately providing for the monies not yet due.

Restoring the road to the company in this way does not affect the right of the trustee to again take possession of the road or foreclose the mortgage for any subsequent default.

Possession and operation of the road by the trustee; lease of the road; operation optional with trustee or with bondholders; rights and liabilities of trustee while operating; income during this period; distribution of moneys received by trustee; his duties while operating road; expenses, contracts, repairs, supplies, and help, incidental to operation; contracts of the railroad company as affecting trustee; liability of trustee for negligence of employees.

As was seen, the trustee is entitled to hold possession of the road he has taken under the terms of the mortgage until the money due is either paid or adequately provided for. The railroad company will not be entitled to repossession until this has been done. So long as there appears to be any need that the trustee shall have possession he is entitled to retain it. Some railroad mortgages authorize the trustee to lease the road to others willing to operate it instead of doing so himself, should he deem such a course advisable. The period and the other details of the lease are sometimes regulated in the mortgage; though they may be left to the discretion of the trustee.

Whether or not the trustee will take possession of the road under the terms of the mortgage and operate it, rests in his discretion, unless there is some provision in the mortgage to the contrary.

Railroad mortgages sometimes reserve to the

bondholders the right to decide whether or not the trustee shall take possession of and operate the road; and, accordingly, the mortgage may provide that he may do so only when requested by the holders of a certain percentage, in amount, of the bonds then outstanding. When the requisite number make the demand the trustee must take possession of the road and operate it. Under such a provision in the mortgage, the trustee may not proceed of his own will; he may only act when requested in the manner specified in the mortgage.

It is not unusual for the railroad mortgage to provide, however, that the trustee may in his own discretion, and must upon the request of the holders of a certain proportion in amount of the outstanding bonds, take possession of the road and operate it.

Railroad mortgages frequently provide that the bondholders shall furnish the trustee with proper indemnity against any loss he may suffer, and against any liability he may incur, in the course of his operation of the road. It will be remembered that the trustee is personally liable to third persons for the misconduct or negligence of his employees and other representatives in the course of the operation of the road by him; his liability to the bondholders is usually limited by the terms of the mortgage to his own wilful wrongdoing or gross negligence.

While in control and operation of the road the

trustee occupies a position of trust towards the railroad company and owes it duties equally as delicate as he does the bondholders.

A trustee operating the road, generally speaking, takes the place of the railroad company. He succeeds to all its rights and is charged with all its liabilities incident to the operation of the road under its franchise. He is entitled to immediate possession for that purpose. Should the railroad company refuse to surrender the mortgaged property to him after proper demand, the court will compel it to do so. The court will also compel the railroad company to account to the trustee for all income received by it during the time the trustee was wrongfully kept out of possession.

The income that the road earns during the period the trustee operates it, and the proceeds of any lease or sale of the property, must be accounted for by him to the bondholders and all others interested.

The distribution of the monies the trustee receives in the course of his possession and operation of the road or from any lease of it is regulated by the mortgage that confers such power to operate or to lease. The usual order of distribution is: that he retain the expenses of the trusteeship, including his own compensation and fees for legal counsel; that he pay the expenses of the management of the road during his possession and the cost of all repairs needed to keep it in good working condition; that he then pay such

claims under liens having priority over his mortgage in the order of their respective priorities; and that then to the payment of the sums due under his mortgage he apply what he then has on hand; and the balance, if any, he shall turn over to the railroad company.

With respect to the payment of the principal of the bonds under his mortgage, if it be not yet matured nor declared to be due, then the trustee first pays the over-due interest, with interest on the delayed interest. If the principal of the bonds be due, or declared due, then he shall pay such principal with interest thereon, with interest on the delayed interest, ratably without any discrimination as between principal and interest and interest on delayed interest.

Should any question arise as to the proper distribution of the monies in the hands of the trustee, he seeks the advice and protection of the court, and pays out only under its direction.

Upon taking possession of the road for the purpose of operating it under the mortgage, the trustee should immediately inform himself fully of the extent of the property that has come under his charge and its condition; what is necessary for its operation, how it can be best preserved and what can be dispensed with without imperiling the security. He is bound to see that the property is not allowed to rust in disuse or depreciate in value. He must get the

road and the mortgaged property in such condition as will make it most productive and most likely to discharge the obligations it must meet. To this end the trustee is entitled to incur necessary expenses. The law gives a preference to these indebtednesses necessarily incurred by the trustee to preserve the property and the value of the franchise. They are entitled to be paid before the bondholders under the mortgage receive anything for either interest or principal of their bonds.

The trustee while in operation and possession of the road may make all those contracts that are incidental to the operation of a railroad.

To operate a railroad the trustee must necessarily employ help, make repairs, purchase supplies and materials, and make the many other contracts incidental to carrying out the duties he has assumed. With regard to these details of management the trustee may act generally as the railroad company might have done had it continued in control.

But contracts of the railroad while it was in possession and operation, and before the trustee took control, are not binding on the trustee unless the mortgage makes them so or the trustee chooses to accept and adopt them.

In a number of States there are statutes regulating the duties and obligations and rights of a trustee on taking possession of a railroad under a mortgage and operating it. These statutes become part of the

mortgage with the same effect as if set forth therein at length.

In operating the road it is the duty of the trustee to employ persons competent to perform the work to which they are assigned. He is answerable for the neglect of his employees when they are acting within the scope of their respective employments. He is personally liable; there is no official liability, as in the case of a receiver, because the trustee is not the officer of the court as is the receiver. He is the representative of the parties to the mortgage and chosen by them. The receiver represents the court that appointed him.

The usual form of mortgage, however, provides that should the trustee be held liable for injuries to persons or property caused by the negligence of himself or his employees in the course of the management and operation of the road, he shall be reimbursed out of the mortgaged property for monies he may have paid out for damages and for any liability he may have incurred. In some of the mortgages, provision is contained that before the trustee shall be required to take possession and operate the road, he shall be furnished by the bondholders with a proper and sufficient indemnity against any loss he may suffer or liability he may incur in the course of such operation.

Some of the States have statutes relieving trustees, operating a railroad, from personal liability for in-

juries caused by the negligence of employees. They make him, like receivers, officially liable only; that is, the recovery of damages in such a case is limited to the property in his control. In the absence of such a statute he is personally liable.

Most mortgages provide that should the trustee become liable for the payment of any damages, or incur any liability, in the course of his trusteeship, whether in the operation of the road or otherwise, he shall be reimbursed by the railroad company; and that should the railroad company not pay him nor indemnify him, then that such sums shall be paid to him out of the trust property, in the safeguarding and management of which he has become thus liable.

Trustee selling the mortgaged property to satisfy claims under his mortgage; exercise of this power may be within the discretion of trustee or controlled by bondholders; details of such sale.

Upon default by the railroad company, the trustee is given the power by the usual form of railroad mortgage to sell the mortgaged road and the other mortgaged property, and to satisfy out of the proceeds what is due under his mortgage. This power must be specifically given by the mortgage; should it be silent on this point the trustee does not have this power to sell.

The trustee is usually permitted to sell with or without entering into possession of the road and the other mortgaged property.

In conferring this remedy some mortgages say that the trustee may exercise it as in his discretion he believes for the best interests of his bondholders. In other mortgages this power in the trustee to sell is made dependent upon the will of the bondholders and the trustee may only sell when requested by the holders of a certain specified proportion, in amount, of the outstanding bonds.

Should the trustee sell the mortgaged property without proper authority, he renders himself liable to the bondholders for any damage they may suffer as a result of his act.

The sale under this power must be made at public auction. The property is sold to the highest bidder. Notice of the sale is given by a series of advertisements in newspapers. The amount and nature of the advertising and all the details with respect to the sale are regulated in the mortgage.

The proceeds of the sale are applied by the trustee as provided in the mortgage, which is substantially in the same order as the rentals and other income received by him during his possession and operation. That is, he pays the costs and expenses of the sale and of his trusteeship, including his own compensation and fees for legal counsel; then he applies the balance to the payment of the principal and

interest with interest on the delayed interest of the bonds under his mortgage. Any surplus remaining is turned over to the railroad company. Should there be prior liens against the property, the property may be sold subject to those liens, in which case the purchaser takes the property charged with their payment; or the property may be sold free and clear of such prior liens, in which case they will be paid out of the proceeds of the sale. All liens entitled to priority over that of the mortgage, are paid in full before the claims under the mortgage receive anything.

The two remedies, just treated, of either selling the road or operating it and then selling, if necessary, are quite generally contained in railroad mortgages, but are not often exercised by the trustee, as each imposes upon him many new duties and new responsibilities. Trustees, therefore, usually place the entire matter before the court by bringing an action to foreclose the mortgage. In this action of foreclosure the trustee asks the court to appoint a receiver to operate the road and sell it under its direction, and thus relieves himself of the responsibilities that are incident to the operation and sale of the road by him.

Foreclosure; outline of procedure.

Foreclosure of a railroad mortgage means that the mortgaged road, and all the other property covered

by the mortgage, and all the rights of the various parties in any way affecting it, are brought before the court. The court then assumes control and administers the property. It ascertains and determines the rights of all the parties who in the end may be found to have any interest in that property before the court.

The court takes physical possession of this property by means of a receiver. The receiver enters into possession of and holds the property thus given into his charge; or, if the court deem it advisable, it orders the receiver to operate the road under its direction.

The foreclosure action then progresses through the different stages of practice and procedure until the decree of foreclosure is reached. This decree of foreclosure states the amount the court has found to be due under the mortgage and orders that the railroad company pay it within a specified time and in case of its failure to do so, directs that the mortgaged property be sold to satisfy the sum so found due. The decree further orders the distribution of the proceeds of the sale. After the sale a final decree is signed by the court confirming what has been done.

The property is usually bought in at the foreclosure sale by a combination formed by the holders of the bonds under the foreclosed mortgage, in which the holders of other issues or the stockholders may join.

Foreclosure by trustee generally; may be controlled by bondholders; rights of majority and minority; foreclosure by bondholders instead of trustee.

The trustee, ordinarily, is the party to foreclose the mortgage. He is the mortgagee: the mortgage is made to him.

In foreclosing the mortgage the trustee does so for the benefit of all the bondholders secured by that mortgage. He represents them all and they are not entitled to be made parties to the action and appear before the court unless their interests are endangered by some wrongful act of the trustee.

The power of the trustee to foreclose is sometimes qualified by the mortgage. The usual qualification in this regard is that he shall foreclose only upon the request of the holders of a designated amount, usually a majority, of the outstanding bonds, and when so requested he shall foreclose. He may not foreclose unless thus requested; and when thus requested he must foreclose.

When no such qualification exists, and he is not taking possession of the road to operate or sell it, he must proceed to foreclose when requested by a minority even against the protests of a majority. So long as there are some bondholders, under the conditions stated, who desire to foreclose, he must do so, when he is not pursuing other remedies under the mortgage. The majority, under these conditions,

have their remedy. They may demand that the trustee take possession and operate the road, or sell it, should that power be conferred on him by the mortgage and they have the requisite holdings under the mortgage necessary to enforce such demand. They may not refuse, however, to enforce their remedies and interfere with others enforcing theirs.

The trustee, when the railroad company defaults, must act; he must pursue some remedy that the mortgage or the law gives him. He may not stand inactive, even at the request of the majority. The trustee represents all the holders of the outstanding bonds of that issue and not a portion, even though that portion be a majority. He must proceed to protect all his bondholders and to realize on the security for them.

Should a majority desire that the trustee do nothing; that he neither take possession of the road, under the mortgage, and operate it or sell it, nor that he foreclose the mortgage, they may stop proceedings only by satisfying the claims of the minority by paying the value of their bonds with interest and the costs of the suit already incurred.

There are circumstances when the bondholders instead of the trustee may foreclose the mortgage. Generally, this is when the trustee has refused or neglected to do so after having been properly requested; or when he is not acting in good faith; or when he is not properly protecting the interests of

the bondholders; or when he has acquired interests that are antagonistic to those of the bondholders; or when he occupies a hostile position toward them. And should the trustee have commenced the foreclosure, the court will permit the bondholders to come in and prosecute the suit, and displace him, when sufficient reasons along the lines indicated appear to its satisfaction.

Should there be a vacancy in the trusteeship the bondholders foreclose.

Bondholders, by a provision in the mortgage, often agree that they shall not foreclose the mortgage but that the right to do so shall vest absolutely in the trustee. Notwithstanding this provision, the bondholders may foreclose the mortgage themselves, when the trustee has lost his right to do so by his bad faith, opposing interests, antagonistic attitude, or in any other way not properly protecting their rights.

When bondholders foreclose the mortgage, instead of the trustee, they act for themselves and all the other bondholders secured by that mortgage. All bondholders secured by the same mortgage have a common interest in the security. What benefits one inures to the benefit of all as a class. The court protects the rights of all bondholders though not appearing personally in the action which has been brought by one or more of their number in behalf of all. The other bondholders, however, may come in and be made parties to the action should they so de-

sire. See *Litigation is conducted by the trustee, etc.* Page 126. Also see *Bondholders may conduct litigation instead of trustee.* Page 128.

When foreclosure sale had.

It may be said that, as a general rule, a foreclosure sale will not be ordered until toward the end of the action, when all the rights and priorities of the parties in the property have been decided by the court. But when the property is in such condition that it may seriously depreciate in value during the progress of the foreclosure, and there is no available money to put it in repair and properly maintain it, the court may order it sold immediately or as soon as circumstances justify. However, to sell the property before the rights of the parties and all contests and disputes have been settled is unusual and will not be done unless special circumstances make it necessary.

Entire road sold as one instead of in separate parcels; foreclosure for interest; lease instead of sale; when divisions are separately mortgaged; mortgages on constituent roads of consolidated company.

The road and the other property included in the mortgage is sold, as a general rule, in its entirety as one lot. This is because railroad property can rarely be divided into parcels and sold separately without injury to the road as a working unit. Each part

depends for its value in a great measure upon the existence and cooperation of the others and all depend for their fullest value upon their concerted and active use. If the unity of the road be maintained so that a purchaser at the foreclosure sale is in a position to continue it as a going concern, it will influence the price advantageously; indeed, it is doubtful if any bid worth considering would be made if the road were not in the condition that it could be operated immediately upon purchase.

If the property be capable of division without injury, it may be sold in separate parcels.

Where the mortgage is foreclosed for failure to pay an instalment of interest, then only so much of the mortgaged property as will satisfy the claim for interest will be sold if the property may be divided without injury. But if the property cannot be divided without injury it will be sold together.

There are times when a sale of the mortgaged property would work an unnecessary injury to the railroad company and its other creditors without gaining anything thereby to the bondholders. The claims of the bondholders may be satisfied, perhaps, without the disorganization of the railroad company and the needless sacrifice of property that the foreclosure may result in. This is attempted by means of a lease. The road is leased to one or more persons, or a corporation, who take it over and work it, paying therefor a stipulated rental. This rental is

paid to the trustee and is applied to the satisfaction of the claims under the mortgage. The court orders the lease for the shortest period that will produce enough money to meet the claims against it. In the lease precaution is taken against the lessee neglecting the property. The lessee is usually required to give security that he will keep the road in good repair and condition during the term of the lease.

Leasing is resorted to when the value of the property is greatly in excess of the amount for which the foreclosure is brought, as when the action is for defaulted interest only.

Bondholders may be secured by a mortgage on one part or division of a road. They then, of course, have no interest in mortgages covering other parts or divisions. They are limited to the division that their mortgage covers. But cases do arise where several divisions have been separately mortgaged and all the mortgages foreclosed at the same time; or two or more roads may have consolidated, having mortgages on each constituent road and then these mortgages may be foreclosed at the same time. In such cases the court may order a sale of the entire road and then adjust the claims of the bondholders under these several mortgages upon the proceeds.

The claims of the several classes of bondholders under their separate mortgages are adjusted according to the value of the part or division of the road upon which they had their respective mortgages. But

this is not the general rule and the entire property is sold only when a sale of each division under each mortgage would be harmful to the entire property. Bondholders under each foreclosed mortgage are entitled to sell the property or division covered by their respective mortgages without being involved in any other foreclosure unless an unusual situation is presented. The courts realize that the sale of a system as an entirety, under these circumstances, would interfere with the opportunity of the bondholders under each mortgage to combine to protect their security without, perhaps, burdening themselves with handling the entire road. Therefore, when there are separate mortgages against separate divisions, each division will be sold separately to satisfy the claims against it unless this cannot be done without injury; then the court will order that all be sold together and adjust the claims of the several mortgages upon the proceeds.

Reasons for combinations to purchase; combinations of bondholders and others; rights of non-participating bondholders.

Every effort should be made to get the best price for the mortgaged road that is to be sold. And the court will aid any endeavor in that direction.

The amount involved is usually too large for individual enterprise. And it is the custom, and almost necessarily so, for the bondholders under the

foreclosed mortgage, with or without others, to combine to purchase and to reorganize railroad property when sold under foreclosure. Without such combinations, the number of bidders would be very limited and take away to a great extent the competitive bidding necessary to prevent a sacrifice of property. For the bondholders to combine in this way is only what prudent men should do to protect their security. The course by which the bondholders unite is to enter into an agreement among themselves, pursuant to which their bonds are deposited with a committee for the purpose of purchasing the road. The committee accordingly purchases the road, organizes a new corporation to take over and operate the road so purchased.

When these combinations are properly entered into and without any intention to defraud any party in interest, they are favored by the courts. The legislatures of many of the States have enacted laws regulating the taking possession of railroad property by persons who have combined and purchased it at a foreclosure sale. Generally, these statutes authorize the purchasers of a railroad at a foreclosure sale to reorganize as a new corporation and to operate the property so purchased with the franchise of the old company. These statutes, in some of the States, create the purchasers of railroad property at a foreclosure sale into a corporation without any formal act on their part. The mere fact that they have

purchased the railroad property at foreclosure sale constitutes them a corporation under these statutes.

Bondholders who have not joined in the purchasing combination are entitled to their proportionate shares of the proceeds of the sale; and they may compel the newly organized corporation to account to them for any property it may have received from the old railroad company, when there is any question as to whether they have received all they are entitled to or not. See Chap. VIII. *Rights and Remedies with Relation to the Reorganization of the Railroad Company.* Page 335.

Persons barred from purchasing at the foreclosure sale; persons who may purchase.

The trustee is not permited to purchase the mortgaged property in his own behalf, without being liable to account to his bondholders therefor. It is rudimentary in the law that one occupying a position of trust and confidence toward property may not purchase that property in his own behalf. The trustee, however, is very often authorized by the mortgage to purchase at the foreclosure sale on behalf of the bondholders at their request: he may then do so.

As a rule any one may purchase at the foreclosure sale whose relations to the property is not one of trust and confidence. The president of the road may purchase as an individual when there is no fraud or unfairness. The attorney for the road may

purchase and take title to the property at foreclosure for the benefit of the bondholders, at their request. A director of the railroad company, however, occupies a position of trust toward it and he may not, therefore, purchase as an individual without permission of the court or the railroad company.

Bondholders may purchase for themselves. Ordinarily, they are the most likely purchasers, because they need not pay their bid in cash.

Rights of purchasers; title acquired; franchise to operate; distinction pointed out.

The purchaser at the foreclosure sale, generally speaking, takes whatever rights the trustee and the railroad company had in the property covered by the mortgage. The decree of sale specifies the property and the interest in it that is to be sold; it must not include anything not covered by the mortgage.

The franchise to operate the road does not pass to the purchaser unless it was included in the mortgage and the decree of sale. However, it is included in railroad mortgages, quite generally, to enable the purchaser to continue the road in operation. The franchise cannot be used without a road; and a road cannot be used lawfully, as against the state, without a franchise. Each loses value without the other; therefore the franchise to operate is usually included in railroad mortgages, so as to give a value to the physical property of the road. Those statutes, as

previously mentioned, which constitute the purchaser of railroad property at a foreclosure sale into a corporation do not confer on them the franchise to operate the road; that must be included in the mortgage and purchased at the foreclosure sale.

When the franchise to operate is included in the sale, the purchaser acquires all the rights the railroad company had to operate the road.

It is not necessary that a corporation should purchase the road or that persons who have purchased should incorporate in order to operate it. The franchise to operate the road may be exercised by individuals. The custom, however, is that a corporation shall operate the road.

That individuals, as such, and without incorporating, may operate a railroad, demonstrates sharply the difference between the franchise of the company to exist as a corporation and its franchise to operate the road. The franchise to operate the road is a special privilege granted by the State. It is usually granted to a corporation already in existence and already exercising its franchise to exist as a corporation.

The franchise to operate the road between certain terminii and over certain territory to the exclusion of all others is owned by the corporation just as it owns any other piece of property.

The franchise to exist as a corporation is also a privilege granted by the State, but it is a distinct and

separate privilege from the franchise to operate a railroad. As was seen, the corporation may be in existence under its franchise to be a corporation before it receives its franchise to operate a railroad; and the railroad company may continue in existence as a corporation after it has lost the franchise to operate the road by reason of its sale at foreclosure. In fact a railroad corporation after it has been stripped of all its property, including its franchise to operate the road, continues in existence until dissolved by legal proceedings to which the attorney general, representing the State, is a party.

The purchaser of the franchise to operate the road does not by reason of that purchase acquire the right or franchise to be a corporation, unless some statute expressly makes such purchasers a corporation by reason of such purchase.

The legislatures of many of the States have enacted laws providing for purchasers of railroad property at foreclosure sales to become incorporated for the purpose of taking over the property and operating it. In some of the States these statutes enable such purchasers to become a corporation immediately upon taking over the property. Some of these statutes declare that the new corporation so created shall have all the privileges and be charged with all the obligations of the old company relating to the operation and the maintenance of the railroad.

Standing of purchaser at foreclosure sale.

The purchaser at the foreclosure sale makes himself a party to the legal proceedings which relate to the sale to the extent that the court may compel him in those proceedings to carry out his purchase. At the same time he becomes entitled to be heard before the court in the foreclosure proceedings on all matters which in any way affect his bid or his liability as a purchaser.

Liability, if any, of purchaser or new corporation for debts and contracts of the railroad company; for mortgages and other liens against the property; sale subject to or free of such mortgages or other liens; transferring liens to proceeds of sale.

The purchaser at the foreclosure sale does not become liable, by his acquisition of such property, for the debts or contracts of the railroad company. Nor does the new corporation which is formed and takes over the road become liable for the debts or contracts of the old company because it succeeds it.

However, if the debts or contracts or mortgages of the old insolvent railroad company are liens on the mortgaged property sold, having priority over the lien of the foreclosed mortgage, the purchaser may take the property subject to such liens. Then the purchaser must satisfy such liens but only to the

extent that the property against which they are a lien will do so. Beyond that there is no liability.

The property may be sold free and clear of all such prior mortgages and other liens. Their liens are then transferred to the proceeds of the sale. Under these circumstances the purchaser takes the property without any burdens as to such liens. This enables him to get the road and operate it unembarrassed by any incumbrances, but requires more money as the purchaser must then pay the entire price.

Should the purchaser take the property subject to prior liens, immediate money for their satisfaction may not be needed, as they may not be due for some time, or if due, provision may be made for their payment at some time in the future.

Purchasers as affected by debts, contracts, and certificates of receiver.

The mortgaged property is also sold, quite generally, free from the lien of the receiver's certificates and the lien thereof is transferred to the proceeds of the sale. The property, however, may be sold subject to the lien of the receiver's certificates, whereupon the purchaser must pay them to the extent that the property against which they were charged will do so. That is, his liability is limited to the property purchased; there is no personal responsibility or liabil-

ity after such property has been exhausted for that purpose. This matter is always taken care of by the decree of the court which fixes the terms of the sale and the conditions under which the property shall be sold.

The purchaser at the foreclosure sale takes the property free from the debts of the receiver, except such as may be specifically charged against such property, as receiver's certificates usually are.

The contracts that the receiver made during his receivership are not binding on the purchaser at the foreclosure sale unless he chooses to accept and adopt them. He is at liberty to reject any or all contracts made by the receiver and to refuse to be affected by them, or some of them; or he may accept them, or some of them, and make them his own with the same force as if he had made them himself.

Effect of foreclosure on claims of general or unsecured creditors; on subsequent mortgages or other liens; on claims of the foreclosing bondholders; on prior mortgages or other liens; certain liens having priority; equity of redemption.

The foreclosure sale cuts off the claims of general or unsecured creditors so far as the property involved in the foreclosure is concerned. Their claims, however, continue against the railroad company.

The foreclosure sale also cuts off all claims

against the property involved in the foreclosure under mortgages or other liens that attached to that property later than the lien of the foreclosed mortgage. These claims, of course, continue against the railroad company, but their lien or special claim against that property is cut off.

The mortgaged property is sold, as a rule, free from the claims of the bondholders of the foreclosed mortgage against it. Their lien with relation to that property is transferred to the proceeds of its sale.

Rights under prior mortgages or other prior liens are not affected by the foreclosure action. Such rights continue superior to those under the foreclosed mortgage. They must be satisfied in full, so far as the property can do so before the bondholders under the foreclosed mortgage receive anything.

A prior mortgage or other prior lien is one that attached to the property prior in point of time to the foreclosed mortgage, or which has been given priority over the latter by consent of its bondholders, or which on account of its nature is made superior and therefore prior to it. The lien for public taxes, for instance, though accruing later than the foreclosed mortgage was executed or took effect, is always superior to such mortgage and is given priority over it. The lien of receiver's certificates and of claims for operating expenses prior to the receivership may also, by reason of their nature, be given a priority, by direction of the court, over the foreclosed mortgage,

though the debts they represent may have been incurred subsequent to the time when the lien of the foreclosed mortgage attached.

By selling the property free from the claims under mortgages and other liens which attached to the property subsequent to the foreclosed mortgage, and also by selling such property subject to those mortgages and other liens that attached thereto prior to the foreclosed mortgage, the bondholders under the foreclosed mortgage are enabled to sell and realize upon the property in the condition it was in when mortgaged to them. But bondholders must always have in mind that the lien of their mortgage may be superseded by the lien for public taxes, assessments, and other governmental charges; and that it may be displaced by order of the court by claims for receiver's certificates and, sometimes, by claims for operating expenses.

It is quite generally the rule that where real estate has been mortgaged and the debtor defaults, and the mortgage is foreclosed, he may redeem the property at any time before, and in some States within a specified period after, the sale by paying all that is due at the time of such redemption. But a sale under a foreclosure of a railroad mortgage cuts off this right of redemption by the railroad company, and the purchaser at the foreclosure sale takes the property free from this equity of redemption, as it is called, unless a statute or the decree of the court reserves this right

to the railroad company. See *Waiving redemption laws, etc.* Page 88.

Time and place of sale; notice of sale; adjournment.

The time when and the place where the sale shall be had are fixed by the court in its decree of sale. These matters rest largely in the discretion of the court.

In appointing a time for the sale of railroad property, the court takes into consideration the condition of the finances of the country and may postpone a sale until better results are more likely.

The property is sold at public auction unless the court shall otherwise direct. The court may order the property sold at private sale; but before doing so it requires that it be fully informed as to the value of the property and the price it would probably bring at a public sale. If it appear to be to the best interests of those concerned, the court may order that the property be sold at private sale.

The sale is conducted by an officer whom the court appoints for that purpose.

All the parties interested are entitled to notice of the time and place of sale. They should receive due notice in advance so that they shall have a timely opportunity to protect their security against a deficiency. The decree of the court states what notice shall be given; but if there is some statute in the

State where the property is sold, which regulates these notices, its requirements must be strictly followed. The usual method of giving notice is by a series of advertisements in newspapers, designated in the decree.

The court, or the officer whom the court has appointed to conduct the sale, may adjourn or postpone the sale on the application of the interested parties when it is shown that it is for the best interests of all that it be done.

Preventing, stopping, or setting aside the sale; reasons therefor; losing rights by delay, by participation; effect of setting aside sale.

Bondholders have the right to have the sale prevented, stopped, or set aside, when sufficient grounds exist. The most common ground is that of fraud in some form.

That the price for which the property was sold is inadequate is not sufficient reason in itself for setting a sale aside. Nor will a sale be vacated because it is likely that the property would bring more on a resale.

To induce the court to interfere on the ground of insufficiency of price, it must be shown that the inadequacy is so great as to excite the suspicion of the court. If the inadequacy of price be so gross as to lead to the inference that it was not an honest sale,

the court will set it aside. And, too, the court will interfere when the inadequacy of price is accompanied by circumstances that suggest fraud.

A combination among bidders is ground to set aside the sale only when fraud is shown. The most common instance of fraud in this relation is the attempt to stifle competition in bidding. A combination between bondholders and stockholders for the purpose of, and which will have the effect of, depriving the unsecured creditors of their rights has been condemned by the courts and the sale under such circumstances set aside.

Those entitled to have the sale set aside must move promptly because by an unreasonable delay they may lose their rights to do so. To excuse delay in this regard it must be shown that the facts urged as the reason for setting the sale aside did not come previously to the knowledge of the one seeking this relief; and that he applied to the court for relief against the objectionable sale within a reasonable time after he acquired such knowledge. But his lack of knowledge of the facts must not be the result of any neglect on his part. He must show that by reasonable diligence he could not have discovered the fraud sooner. But if the means of knowledge be open to him, he is charged with such knowledge that with reasonable diligence he could have discovered. What is an unreasonable delay in one case may not

be in another. What constitutes an unreasonable delay depends upon the circumstances and facts of each particular case.

A bondholder may also lose his rights to object to a sale by participating in the transaction. The law then assumes that by his conduct he has consented to the transaction and thereby loses his right to object.

Should the court set aside the sale, it attempts to put the parties in the same position, so far as practicable, as they were before the improper sale took place. And should setting aside the sale interfere with the rights of innocent third parties, who have in the meantime dealt with the parties or the property and without knowledge of any wrong have acquired rights in the property, then the court will protect such interests as the situation justifies.

Terms of sale; payment of bid by bondholders.

The terms of the sale are fixed by the decree of the court ordering the property sold. It may and it usually does fix a price below which the property may not be sold. This is called the "upset price." In some States there are laws to the effect that before the property of a railroad shall be sold at foreclosure it shall be appraised to determine its value by public appraisers appointed by the court or designated by such statute.

The court may require that each bidder shall make a deposit of a specified sum of money to insure good

faith in bidding. This is a precaution against "straw" bidding. Should the sale not be confirmed by the court, the deposit is returned.

The decree may permit the sale to be made on credit. On account of the large sums involved, railroad property, ordinarily, is not salable if all cash be insisted upon. The court may compel the purchaser to pay in cash a specified portion of his bid and allow him time to pay the balance. When the property is sold on credit, the court continues the lien of the bondholders under their mortgage against the property in the hands of the purchaser for any unpaid balance of the bid.

When the bondholders under the foreclosed mortgage are the purchasers, they are usually permitted to pay their bid with their bonds and coupons after paying in cash the costs of the litigation and such other charges as the court may direct. The bonds and the coupons are then accepted as the equivalent of the sum to which they would be entitled to receive upon a final distribution as their proportionate shares of the proceeds of the sale.

The property of a railroad company, running through two or more States and situated at numerous places, is always, and most naturally so, subject to claims of many kinds and of different legal ranks and priorities; and there follows the inevitable conflict between these different classes of creditors as to

their respective rights and priorities with respect to certain or all of the property of the insolvent road.

Should the trustee, with a railroad in such a condition, attempt to take possession and to operate the road, he may find himself the center of a complex situation, and subject himself to many new responsibilities, liabilities, and embarrassments. As a rule, therefore, he deems it the wiser and safer course to foreclose the mortgage and thus put the entire matter into court and ask it to assume control and administer the property and affairs of the railroad company through its receiver. He does this by bringing an action to foreclose the mortgage.

While the action of foreclosure progresses, the receiver continues the road in operation. Incidental to his management and operation of the road, the receiver employs help, makes necessary repairs, buys needed material, and does such other acts as are necessary to carry out his receivership. The appointment of the receiver and his qualifications, his duties, powers, and liabilities, and his relation to the property in his care, and to the bondholders and the other interested parties, are discussed in detail in the following chapter.

CHAPTER VI

RIGHTS AND REMEDIES WITH RELATION TO THE RECEIVERSHIP OF THE RAILROAD COMPANY

Receivership generally; outline of management and operation of road by receiver.

The foreclosure of the mortgage places the mortgaged property under the control of the court. It is the duty of the court to preserve and to protect this property and the interests of all concerned in it.

The court preserves the property and protects the interests of the parties in it by taking the mortgaged road out of the hands of the officers of the railroad company and placing it in charge of its receiver. The court then administers the property through its receiver. As the value of railroad property consists chiefly in its worth as a working unit and an income-producing and going concern, the court usually continues the road in operation. The receiver operates under the supervision of the court and under the charter of the railroad company. The receiver takes the income of the road during such period and applies it to the expenses of the receivership, making such other payments as the court may direct. He also gathers the assets of the railroad company. In the course of his management, the receiver employs help,

buys needed material and supplies, makes all expenditures necessary to keep the road in operation or to save the property from loss or depreciation. He renders a final accounting at the conclusion of the receivership, and also such intermediate accountings, from time to time, as the court may direct, showing his receipts and disbursements; and he distributes the moneys in his hands as the court orders him. He continues in control until the court directs him to turn over the property. This usually happens when the property is sold at the foreclosure sale or is turned over pursuant to some plan for the reorganization of the road. It takes time to carry out a reorganization of a railroad or to adjust its affairs; the receiver therefore may continue in control and operation of a railroad for a considerable period, sometimes for several years, while a reorganization is being worked out or an adjustment perfected.

Grounds for receivership; when appointed; default in interest or principal; insolvency; inadequate security; when income mortgaged; threatened waste of property; application by railroad company.

The appointment of a receiver is never a matter of absolute right. It is for the court to decide whether or not one is necessary. And before the appointment is made it must be shown to the satisfaction of the court that a receivership is necessary

to prevent loss or injury to those financially interested.

Application for the receivership is made usually by the trustee of the mortgage, and on the ground that the railroad company has defaulted in the payment of the interest or the principal of the bonds, or has defaulted under the mortgage in some other particular, that it is insolvent, and that the security is inadequate. Generally, the fact alone that the company has defaulted in principal or interest of the bonds is not sufficient grounds for the appointment of a receiver, though it gives the right to foreclose the mortgage or otherwise realize on the security. Nor is the insolvency of the railroad company alone sufficient ground for a receivership, unless made so by the statutory law of the state, or unless such insolvency is caused by fraud or such mismanagement by the officials of the company that it is necessary to interfere to save the assets and protect the rights of those financially concerned. A judgment creditor is sometimes entitled to the appointment of a receiver.

However, such default or insolvency in connection with other circumstances, such as, that the mortgaged property is an inadequate security, or that the officers of the railroad company are wasting this property, misapplying the income of the road or otherwise conducting themselves in a manner prejudicial to the interests of the bondholders, will generally influence the court to appoint a receiver.

When it is the duty of the trustee under the mortgage to take possession of the road, upon a default of the company, and he fails to do so or improperly does so, the court will appoint a receiver for that purpose.

Upon the foreclosure of a mortgage covering the income and profits of the railroad company, the court usually appoints a receiver to take these moneys to prevent their misapplication.

As a rule, the receiver is appointed as one of the steps in the foreclosure action; but there are cases when the court may appoint a receiver before the railroad company has actually defaulted under its mortgage and the trustee or the bondholders have the right to sue on such default. Such a case is when the railroad is insolvent and unable to meet its obligations soon to fall due and there is danger that the property covered by the mortgage may be wasted or impaired by its management. Under such circumstances, when the default is imminent, the court, in order to prevent this probable loss, will take the management of the road from those who caused this condition and will place it in the hands of a receiver who will better serve the public and the persons financially interested.

The railroad company itself may, in extreme cases, apply for a receivership, as, when it is insolvent and its property is likely to be wasted or lost if it continues in operation. Dissension, however, in the

management of a railroad company, as a rule, does not justify the appointment of a receiver.

Attitude of the courts towards receiverships of railroads; serving the interests of the public and the bondholders.

It is with extreme caution, if not with reluctance, that courts undertake to appoint a receiver of a railroad, as the effect of the appointment is to suspend the operation of the road by the corporation to which the franchise to do so was given and place it in the hands of a receiver, and in most cases devolving upon the court, to a greater or less degree, the management of the business of the railroad company. Therefore, the need of a receivership must be shown clearly before the court will make the appointment. It must be shown that loss or injury to the property involved will result if a receiver be not appointed.

The court will not take lightly the management of a railroad from the officers of the company and place it in the hands of a receiver. And when it does so it is to preserve the property until the financial embarrassment of the company has passed, or the property is disposed of for the best interests of those concerned, under the circumstances. It seeks to save the security to the bondholders by taking it in its care. Public policy demands that a railroad needed as a means for transportation of persons and property shall not be permitted to rust in disuse and its fran-

chise forfeited; the court, therefore, seeks to serve the public by continuing the road in operation. And, from the standpoint of the bondholders, better results are obtained if the road is continued in operation and sold as a going and an income-producing business, notwithstanding that expenses may be incurred which are paid out of the mortgaged property in full before the bondholders receive anything.

Appointment is discretionary with the court; consent of parties interested; bond of receiver.

Whether or not a receiver shall be appointed is a matter resting in the sound discretion of the court. This discretion, however, is exercised according to precedents which depend, in their application, upon the facts and circumstances that each case presents. Nevertheless, in every case, before the court will appoint a receiver, there must be presented to it facts from which the necessity for the receivership must appear. Those facts and conditions which the precedents have regarded as sufficient reasons for a receivership have been previously discussed. See *Grounds for receivership, etc.* Page 188.

The fact that the interested parties consent to a receivership is not decisive or binding on the court. The court is not bound by their consent. It may ignore their consent and refuse to make an appointment.

As a general rule, the court will require the re-

ceiver before he will be permitted to take possession of the property, to execute and file a bond, with sureties, in an amount fixed by the court, for the faithful performance of his duties as receiver, that he will carry out all orders of the court and that he will render his accounting. The sureties on the bond bind themselves to the effect that the receiver will perform his duties faithfully, that he will carry out all orders of the court, that he will render accountings of the property he has received and of his receipts and disbursements and of all his official acts, whenever required to do so, and that should he fail in any of these particulars, then to those who suffer a loss as a result of his wrongful acts or failure to act, they will pay such damages as may be sustained. The liability of the sureties in the aggregate shall not exceed the amount mentioned in the bond. The bond and the financial standing of the sureties are passed upon by the court should there be any question raised about them.

Effect of receivership on existing rights; on mortgages or other liens; attaching creditors; judgment creditors; suits against the receiver.

The appointment of a receiver does not change the rights of any of the parties in their relation to the mortgaged property. It merely stops, for the time being, the enforcement of these rights and remedies by other legal actions or proceedings. All persons

having claims against the mortgaged property or against the insolvent road must prove their claims in the action or proceeding then before the court in which the receiver has been appointed, and their interests are determined there with the same effect as if each had brought a separate action for that purpose.

The property comes into the possession of the receiver subject to all the mortgages and other liens that exist against it at that time. The receivership does not affect, in any way, the legal standing of such mortgages, other liens, or claims, nor their respective rights to priorities in payment, except that the court may direct that "operating expenses" be paid out of the moneys in the hands of the receiver in preference to other claims; or, it may order the receiver to issue receiver's certificates to raise money to preserve the property, and may order that they be a first lien on that property and paid before all mortgages, certain other liens and claims. See *Operating expenses prior to receivership, etc.* Page 245. See *Receiver's certificates.* Page 210.

The receivership adds nothing to the rights of the parties who procured the appointment. It does not dissolve the railroad corporation. It merely means that the court has taken charge through its officer. And when the court has the property thus in its possession, those creditors who have secured attachments against the company may not enforce them against

the property in the hands of the receiver; nor may those creditors who have sued the railroad company and obtained judgment then enforce their judgments against this property. To do so is a contempt of court and is punishable by fine or imprisonment, or both. The property being in the possession of the receiver, no creditor shall take it or interfere with it without the court's permission. Their claims must be adjudicated in the suit before the court in which the receiver has been appointed, because in that suit the court determines the rights of all parties interested, in any way, in that property.

After a receiver has been appointed, no suit may be brought against him in his official capacity without permission of the court. To do so is a contempt of the court, for the receiver is the officer of the court and shall not be interfered with in his possession of the property or the performance of any of his duties without permission of the court.

Ancillary receiverships; road running through two or more states; appointment of same receiver in each jurisdiction; jurisdiction of courts of each state; may appoint their own receiver.

Courts have no power to appoint a receiver to act outside of the State or the territory over which they have jurisdiction. The jurisdiction of the courts of each State is limited to the territory embraced within that State. The jurisdiction of a Federal court cov-

ers only the territory within its own district, which in some districts extends over several States. The receiver has no power to act in places over which the court that appointed him has no jurisdiction.

Where a road runs through several States and beyond the jurisdiction of the court that first appointed the receiver, the management of the entire road is usually placed in the charge of the receiver first appointed, by the courts of the other States appointing him as their receiver to act within their respective jurisdictions. These second appointments, by these other courts, are called ancillary receiverships. Should each court appoint a different receiver, confusion is inevitable. Such ancillary receiverships are made, therefore, to bring about harmony of management and the satisfaction that results therefrom.

However, the court making the ancillary appointment does not surrender its powers to make such orders with regard to that portion of the road within its own jurisdiction, as it may deem necessary for the best interests of all the parties in the different proceedings. The court of ancillary appointment while, as a rule, it directs the receiver to follow the orders of the court of initial or original appointment, may disregard them and may direct the conduct of the receiver within its own jurisdiction, according to its own orders.

Should the courts of the different States or juris-

dictions through which the road runs refuse to appoint the same person as receiver within their respective jurisdictions, then each may appoint its own receiver to act within its jurisdiction, under its direction, and with or without regard to the orders of the other courts.

But it is universally recognized that conflict and confusion must follow where concurrent receiverships control a railroad; therefore, notwithstanding the fact that each has the power to act independently of the others, the courts of this country, through the comity between them, as a rule, make ancillary appointments of receivers, and each directs the receiver within its jurisdiction to carry out the orders of the court that first acquired control of the road and made the original or initial appointment. However, each court will do so only when such orders are not against the public policy of its own State or do not conflict with or violate any of its own laws. They will try to follow the course of the court of initial appointment, so far as they consistently can, so that they may grant to their own citizens remedies and rights equal to those enjoyed by the citizens of that other State.

Receivership of parent company and of branch or subsidiary lines.

When a receiver has been appointed for the parent or controlling company of a system of railroads, the

bondholders secured by mortgages on the branch, controlled, allied, or subsidiary lines or roads may have their own receiver for each mortgage to represent their respective interests in each of such roads or lines.

Who is chosen as receiver; consent of parties; his qualifications.

The courts select as their receivers those who are acceptable, so far as can be, to all parties. Some railroad mortgages provide that the holders of a certain proportion of the outstanding bonds under that mortgage shall have the right to nominate a receiver. The person that the bondholders thus nominate, or that the parties to the litigation may have agreed upon, and urge upon the court for appointment, need not necessarily be its choice. However, the court is generally influenced by the consent of the interested parties; though it may ignore their suggestion and appoint whom it believes will best serve the interests of all concerned. The interests of creditors of all grades and of all persons who may be affected by the receivership are considered in the appointment.

The court usually selects as its receiver a person of recognized ability and standing, in whose hands all can feel assured that their interests will be honestly and ably taken care of. He should be disinterested. The court will not appoint any one whose

interests are opposed to those of the bondholders or others interested in the property.

An officer of the railroad may be appointed receiver. If the insolvency which caused the receivership resulted from mismanagement of the affairs of the railroad company, the court will not appoint any one connected with that management. As skill and experience in the management of railroads together with a knowledge of the affairs of the road in question are desirable, the court may appoint an officer of the railroad company when its insolvency was not due to any fault on his part.

Receiver represents the court; subject only to its control.

The receiver represents no class of creditors; not even that class of creditors at whose instance he was appointed. His possession of the property in his care is that of the court that appointed him. The court holds the property with the hands of its receiver as its officer, and he is responsible to it for all his official acts. The receiver is the arm of the court doing its bidding. He is in no way subject to the direction of the railroad company, the trustee, the bondholders or any other creditors.

The receiver must carry out the orders of the court as they are issued, from time to time, and his failure to do so may render him personally liable in

money damages and also for contempt of court. His sureties become liable for any money loss suffered because the receiver does not carry out the orders of the court.

General powers and duties of receiver while operating the road; application to the court for instructions and authority; what the court generally allows the receiver to do.

Immediately upon his appointment the receiver takes possession of the property covered by the mortgage, and gathers all these assets. He should then proceed upon such a course as will save to the bondholders, the other creditors, and all other persons interested financially, the largest amount in the shortest time. He should study carefully the problem, not only how to conserve the security of the bondholders, but also how to serve the interests of the public.

His appointment gives him the right to the immediate possession of the property over which he is appointed. The court protects the receiver in his possession and control of the property it has placed in his charge, and any unjustifiable interference with him in the discharge of his duties and the possession of the property is a contempt of court, punishable by fine or imprisonment, or both.

In continuing the business of the railroad company, the receiver has substantially the same powers

as the railroad company has and is subject substantially to the same liabilities as it is. He has the right to use the charter under which the company operated.

When the receiver is in doubt as to his rights or powers he should apply to the court that appointed him for advice and instruction.

If necessary for the profitable operation of the road, the court may authorize its receiver to complete an unfinished branch line or other work. When advisable and likely to be productive of good results, the court may authorize the receiver to make traffic contracts with other companies or carry out those already made by the railroad company; also to lease property to others or to lease property from others, when necessary for the advantageous operation and management of the road. The court will also authorize him, under proper conditions, to borrow money to purchase rolling stock and materials and to pay for labor necessary for the operation of the road.

The court may permit the receiver to settle or to compromise claims against the railroad company. Generally, the receiver should pay no claims against the railroad company unless permitted by the court.

The court will ratify or subsequently approve any act done by the receiver without authority if it be such as it would have permitted if previously applied to. Those contracts, expenses, or other acts which the court usually authorizes in the first in-

stance, or subsequently ratifies or approves, are, generally, those necessary to preserve the property and maintain the road in operation.

Discretion of the receiver in the management and operation of the road.

Should the receiver be compelled to obtain permission from the court for every act incidental to the management and operation of a great business like a railroad it would seriously interfere with, if not prevent, the carrying out of the very objects of the receivership. It would necessitate the court passing upon every detail of the business and would take up its entire time to the exclusion of other litigation.

Therefore, while the receiver is always under the control of the court, yet in the operation and management of the road, he is authorized by law to act according to his best judgment with respect to those ordinary and necessary matters arising incidentally. He is permitted a reasonable discretion. Under this discretion which the law gives him he may make repairs to keep the road in proper condition; he may dismiss any of the employees of the company and engage others in their places. He may engage legal counsel when necessary. As to such matters and those others that arise incidentally in the management and operation of the road he need not ask permission of the court, but may act according to his own discretion.

Effect of the contracts of the insolvent road on the receiver; leased lines; leases of rolling stock; car trust agreements.

The contracts which the railroad company made while in possession and operation of the road confront the receiver upon taking charge. Such contracts may be a lien on the property the receiver takes over; they are then binding on him to the extent of such lien. Where such contracts are not liens against the property the receiver is not bound by them unless he accepts and adopts them. That is, he may reject those he believes unprofitable or undesirable, and may accept those he believes beneficial. He must make his decision within a reasonable time after his appointment. His discretion, however, is neither arbitrary nor absolute nor uncontrolled. His action in this particular is subject to review by the court. He must act in good faith.

The court will not permit him to accept and carry out those contracts that are prejudicial or which may diminish the assets or otherwise prove harmful. Should the receiver adopt or show an intention to adopt objectionable contracts, the interested parties who may be harmed thereby may apply to the court for relief. The official acts of the receiver are always subject to the control of the court.

When the receiver takes over a railroad, he usually finds that the road is operating one or more lines by means of a lease, and using rolling stock under a lease

or a "car trust" agreement. Rolling stock comprises the cars and locomotives used in conveying persons and property, that is, employed in the business of a railroad company.

Whether or not the receiver shall continue to operate the leased line under the lease and adopt it is, under the rule stated, for him to decide. He has a reasonable time within which to make his decision. In the meantime he may continue to operate such leased line and his so doing will not be construed as an acceptance and adoption of that lease by him. However, while operating the road under the lease during this tentative period, he must pay for its use. If the lease is adopted then the receiver pays the amount agreed upon in such lease. Where the lease is ultimately rejected, then the court will fix the amount of compensation to be paid to the lessor of the leased road for the time the receiver used it. The amount that the court fixes is not necessarily at the rate mentioned in the lease, but is the fair and reasonable value for that period, depending upon the circumstances under which he took and operated such leased road. The amount ordered to be paid may be at the rate mentioned in the lease if that be the fair and reasonable value.

The same rule applies to the rolling stock used by the railroad company under a lease. Should the receiver adopt the lease of the rolling stock or the court order him to do so, the rental mentioned in the

lease under which it was used must be paid. The receiver or the court may refuse to adopt the lease, whereupon the property is turned over to its owners; however, should the receiver have need for this rolling stock, notwithstanding his rejection of the lease, he may continue using it. And for the time that he uses it, he must pay what its use is fairly and reasonably worth during that period. This fair and reasonable value may be at the rate fixed in the lease, though not necessarily so. The amount that the receiver pays is what the court fixes.

The rolling stock may be used by the railroad company under a "car trust" agreement. Under such an agreement, the railroad company uses rolling stock belonging to an association, paying rent periodically for its use for a specified time (usually ten years), and on the understanding that at the end of that term the aggregate of all the rentals shall constitute the purchase price, and that thereupon the railroad company shall become the owner of the rolling stock. The court may order the receiver to continue the payment of rentals and thus complete the purchase, which is usually done when the greater part of the sum has already been paid. See *Car Trust Certificates or Bonds*. Page 316.

Should the court deem it advisable not to continue this "car trust" agreement—which is usually done when only a small part of the purchase price has been paid—it may order the property turned over

to its owners. However, the court may refuse to adopt the "car trust" agreement and yet direct the receiver to continue using such rolling stock; the receiver then pays to its owner what its use is fairly and reasonably worth for the period he uses it. What shall be the fair and reasonable value is determined by the court.

Such use of the property of another after refusing to be bound by the agreement under which it was originally taken may seem an arbitrary disposal of its owner's rights in his property, but it is justified on the ground that it is railroad property that the court has taken in its care, property charged with the obligation to continue as a public highway, in which those persons having private property rights are not alone interested, but in which the public is vitally concerned. And there are times, such as these, when public interests demand that private interests in property give way to them. Persons dealing with railroads or railroad property are charged with a knowledge of how the law regards property and corporations of this character and must have in mind what may follow.

Expenditures by the receiver.

The details of the management and operation of the road are left, to some extent, as was seen, to the discretion of the receiver. So, too, he is allowed a certain discretion as to expenditures in the course of

his receivership. This exercise of discretion must be characterized always by good faith.

The receiver is permitted by law, without first obtaining permission of the court, to expend such moneys and incur such obligations for expenses as are necessary to preserve the property and operate the road in its ordinary management, provided they are not for a large amount or for an unusual purpose.

When unusual matters arise or large expenditures are called for the receiver must apply to the court for permission to act.

The necessity, the nature, and the amount of the expenditure determines its propriety.

Expenditures for large amounts or for unusual purposes; making unusual contracts.

Before acting in a matter involving a large amount the receiver should first get authority from the court to do so. The same rule applies to expenditures for unusual purposes. Nor should he make any contract that is unusual or which by its terms will extend beyond the probable period of his receivership, without permission from the court. Should the receiver make expenditures for a large amount, or for an unusual purpose, or enter into a contract that is unusual, without first obtaining permission from the court, he takes the risk of what the court will subsequently do in the matter. The court may approve

his acts, or it may only partly approve them, or it may refuse entirely to sanction the expenditure or the contract in question. Should the court withhold its approval, the receiver, having acted beyond the scope of his authority, will be held personally liable and the property in his care as receiver will not be bound by or charged with such contracts or expenditures. However, where the property has been actually benefited by such expenditure, the court may permit such sums as benefited the property to be allowed and to be paid as an expense of the receivership.

With respect to expenditures for large amounts, or for unusual purposes, or the making of unusual contracts, the court will not authorize them in the first instance, nor subsequently approve them, unless they are necessary to preserve the property and maintain the road in operation.

Ordinarily, the court will not permit the receiver to expend money to complete unfinished work. The objection is that it is entering upon a new enterprise and casts upon the property in the hands of the receiver an additional burden. But when absolutely necessary to preserve the property and prevent deterioration or loss, the court may, under some circumstances, permit the receiver to complete unfinished work. On this proposition no fixed rule can be laid down; the action of the court on the question of finishing uncompleted work depends upon the

particular facts and circumstances of each case before it.

Income during receivership; how applied; anticipating income.

The income taken in by the receiver is used first to pay the expenses of the receivership. Expenses of the receivership include the cost of maintaining and operating the road, wages of help, claims for repairs and materials furnished in the course of operation, and the rentals of leased lines and leased rolling stock.

Should there be insufficient income to pay the expenses of the receivership, they may be charged against the property itself.

Should there be sufficient income left after the expenses of the receivership are paid, to pay the interest that was defaulted on the bonds whose mortgage is being foreclosed, or the interest accruing thereon and falling due during the foreclosure action, the court may order it paid; if not, or if the court cannot safely make such an order, it will not do so. And sometimes even though there be enough to pay the interest mentioned, it will be withheld by the receiver to meet operating expenses shortly to fall due or to be incurred; or it may be withheld to pay claims that, by law, are given a preference, and which the court may order paid first.

Judgments and claims for injuries to persons or

property caused by the receiver or his employees in the course of the operation of the road are also paid out of the income earned by the receiver as an expense of the receivership.

Should the income of the road be insufficient to meet current expenses, or to make repairs or improvements necessary to preserve the property, the court may anticipate future income by ordering the receiver to borrow money and may secure such indebtedness by making it a first lien upon the property in the possession of the receiver.

The receiver borrows money, under these circumstances, by issuing and selling receiver's certificates.

Receiver's certificates; only when absolutely necessary; unusual security; lien the court gives them; several issues; when payable; rate of interest; selling price; obligations of receiver; their form and transfer; enforcing their payment; reasons for displacing bondholder's lien; notice to bondholders; entitled to be heard.

The receiver ordinarily pays the expenses of operating and maintaining the road during his receivership out of the earnings of that period. However, when current income is insufficient to pay current expenses, or should money be needed to preserve the property by making improvements or otherwise keeping the road in a proper condition of efficiency, the

court may order the receiver to borrow money to meet these requirements. The receiver then under the direction of the court issues receiver's certificates, which are sold to raise the necessary money. Good results must be likely from the use of the money thus raised; and if such money is not absolutely necessary, the court will not order the certificates to be issued.

It must be apparent that investors are not likely to lend money to be secured by property a mortgage upon which is already under foreclosure, and a receiver appointed on the ground that the security is probably insufficient to meet the demands already against it. An extraordinary security must be offered. Therefore, for the payment of the receiver's certificates the court pledges its faith and the property in its custody, and gives these certificates such lien against this property, or priority in payment out of its proceeds, as the situation justifies.

The court usually makes the receiver's certificates a first lien upon the franchise, income, and property of the road that is in its care, and orders that the certificates shall be superior to all other liens, except of course, those for public taxes. While the certificates are usually made a first lien, the court may order that they be a first and prior lien only as to some of the liens against the property and a junior, subsequent, or inferior lien as to others. The order of the court authorizing the certificates states just what legal position or lien they shall have with

relation to other liens and to the property against which they are charged.

When some bondholders ask that receiver's certificates be issued, and others do not join in that application, or they are issued against the protests of the latter, the court may place the burden upon those who originally asked for them. That is, it may direct that the certificates be a lien upon only such proportion of the property, or its proceeds, as the holdings of those bondholders who asked for the certificates, bear to the entire bonds outstanding and secured by that property; and that the certificates shall not affect the rights, or the interests, or the lien on the property, of those bondholders who have opposed the issue. But, as was seen, the court may, notwithstanding the objection of the dissenting bondholders, displace their lien and give the receiver's certificates a prior lien.

Where there are several issues of certificates their respective ranks are fixed by the court.

When the certificates are made a first lien they are paid out of the proceeds of the property they are charged against before any other claims, except those of a public nature, as taxes, are paid therefrom; or the property may be sold subject to the lien of the certificates, when payment may be enforced out of the property in the hands of the purchaser; or they may be made a condition of reorganization of the road, whereby the new corporation shall be-

come liable for their payment and satisfy them in money or in securities of the new corporation.

Should the proceeds of the property be insufficient to pay all the certificates of that issue in full, the holders share proportionately.

Receiver's certificates are made payable either at a fixed time or when the property shall be sold or disposed of by the court. The order of the court authorizing the certificates states when they shall be payable,—at a fixed time or upon the sale or other disposition of the property.

The rate of interest the certificates shall bear and the price at which the receiver may sell them is also fixed by the court. Should the court make no order permitting the receiver to sell at less than par, then he may not do so. Should the receiver sell at less than par, without permission of the court, the purchaser is entitled to demand and receive only what he actually paid. But if the court authorized their sale by the receiver at less than par, a purchaser at the authorized price is entitled to demand and receive their face amount.

Receiver's certificates are the obligations of the receiver and not of the railroad company. They may be made negotiable in form, that is, payable to bearer or to the order of a named payee and assigned by him in blank. They are not, however, negotiable instruments in the strict legal sense of the term, such as promissory notes or bonds may be.

When the certificates are payable to bearer they are transferable by mere delivery from hand to hand without any writing or any formality other than their manual delivery. When payable to order they are transferred by written assignment and delivery.

As a general rule, the holder of the certificate is not entitled to sue for its payment by a separate action. His remedy usually is to apply for relief to the court that has the foreclosure proceedings in charge, and which ordered the certificates to be issued. But where the property is sold subject to the lien of the certificates, the purchaser thereby taking the property over subject to their payment, an independent action will then lie against such property in the hands of its purchaser.

It is an extraordinary power that the court assumes to exercise in displacing the lien and the priority of the bondholder's mortgage in favor of the certificates of the receiver. This power is exercised only in the cases of railroad and other quasi-public corporations. Corporations of this nature, though composed of private individuals united for private gain, are engaged in enterprises that serve the public and are immediately connected with the public welfare. The franchises or special privileges necessary to carry on the enterprises in which they are engaged are obtained from the people of the State. The people, therefore, who have given these valuable franchises are vitally interested in seeing that such

enterprises (as the exclusive means of transportation of passengers and freight between certain termini) shall continue in operation and that these special privileges or franchises shall not be neglected. Should a railroad suddenly cease operation, it would interfere with business and social life, arrest progress and development, and be a serious public loss, the extent of its harmful effect depending upon the size and location of the road. The railroad company when it accepts its franchise from the people assumes the duty to maintain and operate the road and serve the public from whom it has accepted this special privilege. And it is this duty and that it shall be performed, that the court has in mind, to a great extent, when it appoints a receiver to continue the road in operation and permits him to borrow money to do so. And all persons are charged with a knowledge of this duty to continue maintaining and operating the road; and all persons are charged also with the knowledge that when necessary to carry out this duty, the receiver may be permitted to borrow money, and to secure same may issue certificates which may be made a first lien on the property of the railroad corporation, displacing the liens of mortgages to secure bonds.

And from the standpoint of the bondholders it may be urged that rapid diminution of the value of the property covered by their mortgage would follow if it were not for the timely aid of the money raised

by the certificates. The true value of railroad property lies in its worth as a going concern and in its income earning capabilities. And while it may seem a hardship on the bondholders to have their lien displaced by the certificates, it must be remembered that the money raised by them comes at a time when it can be used most advantageously to give life to the security and to continue it in existence, or to make it more efficient, and thus produce better results than would have been probable without it.

Nevertheless, the courts approach the subject of receiver's certificates with great caution as the certificates may defeat the very purpose for which they were employed. For, while they are intended to preserve and improve the mortgaged property and enhance its value by keeping it going as an income-producing business so that the bondholders who have had their lien displaced may realize more than they would have done if their property had been left in its original condition, it has happened that such results have not followed and that bondholders have been "improved" out of the equity they originally had in the property. It, therefore, must be shown to the satisfaction of the court that the saleable value of the property will be increased as a result of the use of the money to be obtained by the certificates, before it will order that they be issued. The court will refuse to order certificates if it believes the result doubtful.

The condition of the property may be such that the court may consider it more advisable to stop running the road and hasten matters to a foreclosure sale.

Accordingly, receiver's certificates are issued only when absolutely necessary and when good results are likely. And the purpose for which they are issued is limited to raise money to preserve, to repair, and to equip the road and to maintain it as a going concern. Courts will not, as a rule, order certificates to be issued to complete unfinished work beyond what is necessary for the preservation of the property in its care.

Before the court permits the receiver to issue certificates, the bondholders must receive notice of the application and must have an opportunity to be heard. They are entitled to their day in court. Bondholders are protected in the security that the lien of their mortgage gives them and this priority will not be taken from them without their consent. However, to depend upon an actual consent would often defeat the issuance of the certificates. The unwarranted and unfounded objection of some of the bondholders is not permitted to interfere with nor to thwart an act intended for the good of the greater number and the public, and in which the court seeks to safeguard the interests of each individual as well.

At the hearing the bondholders are entitled to show that the certificates are not necessary and,

among other objections, to urge that they will do more harm than good to the security, that the amount for which it is intended to issue them is excessive, that they should not be given a rank superior to the lien of the mortgage being foreclosed.

When the affairs of the railroad company have reached a receivership, the bondholders usually place their interests in the hands of a committee. Such a committee is then the representative of the bondholders to the extent that they are bound by whatever it does in their behalf while acting within the scope of its authority. This committee usually has the power to consent, if in its judgment it be advisable, to the issuance of receiver's certificates. Such committee does not represent those bondholders who have not consented to it acting for them. Those bondholders who are not parties to the agreement which appointed the committee are not bound by the acts or consents of this committee.

The order which the court makes authorizing the certificates and fixing their lien is such as, under the circumstances, it believes will best serve the interests of all the parties.

If the certificates are issued beyond the amount authorized, the excessive part of the issue is void; but if the money received from the sale of such excessive part has been used to benefit the property, the court will aid their holders to get their money. Records of the court are accessible to all persons who

may satisfy themselves whether or not the certificates have been regularly issued.

Official liability of the receiver; his personal liability.

In operating the road, the receiver, through his representatives, may cause injury to persons or property; or he may employ help, or purchase materials, equipment or other property. When he is acting thus, he is acting in an official capacity; he then is officially liable only. That is, to pay such damages caused persons or property, or to pay such wages for help, or to pay the purchase price of such material or other property, only the property in his possession as receiver (official property), can be reached. He is not personally liable in such matters, and neither is he nor are his sureties liable on the receiver's bond. These are receivership liabilities, incurred while acting as an officer of the court, and they must be paid only out of receivership property.

The receiver, however, is personally liable if he personally caused the injuries or the damages just mentioned; or if he failed to exercise reasonable care in the selection of the employees who did. He is also personally liable if he pledged his individual credit in the hiring of help or the purchase of any property.

The railroad company is not liable for the acts of the receiver where he is in entire possession and con-

trol. The railroad, therefore, is not liable for injuries to persons or damages to property while the road is operated exclusively by the receiver. Should the receiver and the railroad company jointly operate the road the latter continues liable.

Liability of sureties on receiver's bond.

The receiver may be required by the court to turn over certain property, or to make certain payments, or to do other acts specified in its order. Should he fail to obey the orders of the court in any of these particulars, then those who are entitled to receive such property or such payments, or to the benefits of such other acts, may recover from the receiver, personally, damages for any loss they may suffer by reason of his failure to obey the orders of the court in such respect. These orders are directed against the receiver personally. If it be shown that the receiver cannot pay such damages, then the sureties on the receiver's bond are liable; and upon obtaining permission of the court they may be sued on their bond.

Accounting by the receiver.

The receiver must render an accounting to the court that appointed him. Each person interested in the receivership is entitled to know, from time to time, what the receiver is doing.

He must keep his accounts and vouchers for pay-

ments made by him so that all persons interested may examine them at reasonable times.

At the conclusion of the receivership, the receiver renders his final accounting; and he must also account at such other times, and as often as the court directs him to. A failure to comply with the order of the court in this respect is cause for his removal.

The accounting of the receiver is filed with the court for its approval. Any person interested as a party or claimant may object to any or all of the items of the accounting. A hearing is had before the court on these disputed items. Sometimes the court itself passes on these items in dispute; usually the accounting is sent by the court to a referee or master to examine into all items, disputed and otherwise. The referee or master reports his findings to the court for final approval or disapproval. In passing upon the accounting the court specifies the sums it allows for compensation to the receiver, to legal counsel, and for other services.

The books of the railroad company in the possession of the receiver should be open at all reasonable times to the inspection of the parties interested.

Removal of the receiver; his resignation.

The court that appointed the receiver may remove him from office. Any attempt on his part to advance his own personal interests at the expense of the property or funds in his care is cause for his

removal. So, too, is his collusion or any other impropriety in procuring his appointment. The incompetency of the receiver is ground for his removal. A mere error in judgment, where there is no bad faith, will be pardoned. But should errors of judgment show a lack of capacity, the court will remove the receiver. Failure of the receiver to render an accounting when ordered to do so by the court is sufficient cause for his removal.

Generally, the receiver will be removed for any misconduct that subjects the property to danger.

Should there be more than one receiver, a lack of harmony among them that menaces the rights of the bondholders and the others concerned in the receivership is good ground for the removal of all. The court then usually appoints one receiver in their stead. Other situations may arise when the court may deem it advisable that the receivership be placed in different hands for management.

As has been said so many times, the receiver is the officer of the court and bound to do its bidding, and when he has undertaken his duties he may not avoid them arbitrarily by resigning. He must obtain permission of the court to resign. The courts usually give the receiver permission to resign, under proper circumstances, and then appoint another in his place.

The removal of the receiver does not in any way affect the receivership. The rights of all remain the same. The only change that takes place is that the

court now acts through a new receiver in place of the deposed one.

Compensation of the receiver; fixed by statute or the court; forfeiting compensation; paid out of property or by contribution.

The receiver is allowed compensation for the services rendered by him in the proper discharge of his duties.

In some of the states the rate of compensation is fixed by statute. He is then paid according to that rate.

When there are no statutes fixing the rate of compensation, it is determined by the court. In doing so, the court considers the amount of work the receiver actually and necessarily did, the manner in which he performed his duties, the fidelity and business capacity he brought to bear, the amount involved, and the responsibilities he assumed. The court bases its determination upon the particular facts of each case. The court allows a lump sum. The percentage basis of compensation is not used by the court. And in arriving at that sum the salaries paid to public officers for similar services are sometimes used as a standard. The salary of the president of the road has in some cases been considered a measure of compensation. In some instances this would be insufficient and in others excessive. As has been said, each case depends upon its own particular facts.

Where the misconduct of the receiver has been such that the court believes he is not entitled to any compensation, having forfeited it by his misbehavior, it may refuse him any compensation whatever.

The receiver is compensated out of the property in his charge. Should that property fail or be insufficient to adequately compensate the receiver, then the bondholders and those others at whose instance he was appointed must provide, by assessment or contribution, the money necessary for his payment. But where the receivership was procured by the bondholders under a second mortgage, the prior mortgage bondholders are not assessed or otherwise held to contribute unless they took an active part in the litigation.

Termination of the receivership.

The receivership serves but a temporary purpose: it comes to an end when its objects have been accomplished. Then, there being no further necessity for its existence, the court will discharge the receiver, and relieve him from further liability. The receiver is usually discharged after the foreclosure sale or when the reorganization of the road has been carried out. There is then no longer any property to take care of and there is no longer need for his services. The receiver now renders his final accounting and is discharged by the court, unless it believes it is necessary to continue him in office for a while to close up

other matters that may have arisen. When the receiver shall be discharged and the receivership terminated rests in the sound discretion of the court. The receivership must not be prolonged unnecessarily; but it will be continued so long as the court believes there is need for it.

The moneys the receiver takes in during his operation of the road, and the proceeds of the sale of the property under foreclosure or otherwise, are distributed under the direction of the court. Usually there are many claims of different kinds. Some are entitled to be paid out of certain property, or its proceeds, to the exclusion of all others. Sometimes several classes of creditors are entitled to share proportionately in a fund; sometimes they share according to their respective priorities or preferences, as to which there may be a conflict. These priorities or preferences in payment depend in some instances upon the fact that the mortgage or other lien which gives them such priority or preference attached to the property in question before the lien of the others; or because of the nature of the claims; or because by order of the court they have been made a charge against certain property; or because some bondholders, having a certain priority, consent to waive it in favor of others who have advanced money to the road at a later and critical time; or because of such other reasons as the complex conditions that the insolvency of the road presents.

These priorities and preferences in payment out of the property and funds before the court, and the reasons for each, and the general rules applied in the distribution of the assets of the insolvent railroad company, are discussed in the following chapter.

CHAPTER VII

RIGHTS AND REMEDIES WITH RELATION TO THE ASSETS OF THE INSOLVENT RAILROAD COMPANY; RIGHTS AND PRIORITIES OF THE OTHER CREDITORS

General rules of distribution of assets of the insolvent road; mortgages and other liens; secured and unsecured creditors.

As a general statement it may be said that such property of the insolvent road upon which there are mortgages or other liens is reserved to the payment of the claims secured by these mortgages or other liens; and such claims so secured are paid in full, according to their respective priorities, out of that property before any other creditors receive anything from it.

When a mortgage is foreclosed and property is thus before the court, it orders it sold and the proceeds of the sale are distributed under its direction to those whom it finds to be entitled thereto.

When the property is sold under foreclosure, the costs and expenses of the foreclosure action and of the sale are paid first. Then those claims are paid

that the statutes of the State give preferences to, and those which the court orders to be preferred. After claims of these classes are paid in full, the balance of the proceeds of the property is applied to the payment of those who have mortgages or other liens against the property sold. These claims secured by such mortgages or other liens are paid according to their respective legal ranks and priorities. After all these claims are paid in full the balance, if any, is paid to the general or unsecured creditors. Should there be anything left after all these payments are made in full, it is turned over to the railroad company.

In addition to those creditors who have secured themselves by mortgages or other liens, and those to whom the statutes of the different States give a preference and priority, there are claims, such as receiver's certificates and operating expenses, to which the court may give a certain preference out of income or property itself, depending upon the circumstances of each case, and which it orders paid sometimes before the bondholders and the coupon holders under the defaulted mortgage.

Each class of creditors is paid in full before those of the succeeding class receive anything.

Should there not be enough to pay all the creditors of a class in full, they share proportionately. For any unpaid balance they become general or unsecured creditors; they then share proportionately

with the other unsecured creditors in whatever fund that may be left for such unsecured creditors.

The funds to which the general or unsecured creditors have recourse are those produced by the proceeds of all property upon which there are no mortgages or other liens; and in addition all that remains of property upon which there are mortgages or other liens, after such mortgages and other liens have been satisfied in full.

Claims not yet due are also paid, but with a reduction of interest for the unexpired period.

Income earned by the railroad company before default; after default; income earned by receiver.

We have just seen generally how the property of the insolvent road, when sold under foreclosure, is distributed. To the distribution of certain income that the road earns, rules are applied that should receive separate consideration.

The railroad company is entitled to the income it earns, as against the bondholders, while it is in possession and operates the road. This is so even when the income is mortgaged and specifically included in the mortgage. Mortgaged income means net income. Net income is what is left of current income after payment of expenses necessary to produce it. See *Operating expenses prior to receivership.* Page 245. For it is the duty of the railroad company while in operation to apply its current income

to the payment of its current expenses. Its current income, therefore, after the payment of the current expenses necessary to produce it, thus making it net income, belongs to the railroad company until it defaults under the mortgage and the receiver under order of the court or the trustee under the mortgage, as the case may be, demands possession of the mortgaged property. Thereupon it belongs to such receiver or trustee.

Even when mortgaged, the trustee or the receiver, as the case may be, is entitled only to the income earned after the company defaults under the mortgage and such trustee or the receiver has demanded possession.

Should the railroad company turn over any income to the receiver then these moneys, together with such income as he may earn himself, are applied generally first to the expenses of the receivership. Such expenses include all costs of the foreclosure action, reasonable compensation for the receiver and his legal counsel, and the other necessary expenditures to properly maintain and operate the road.

Accordingly, claims of employees for wages, claims for materials furnished and for work done during the receivership are paid as its expenses.

Those claims for labor and materials furnished to the railroad company during the period of about six months prior to the receivership which were necessary to maintain and preserve the mortgaged prop-

erty, and which come under the classification of "operating expenses," are also paid out of the income thus in the hands of the receiver. See *Operating expenses prior to receivership.* Page 245.

Claims or judgments for damages for injuries to persons or property caused while the road was operated by the receiver are also regarded as expenses of the receivership; but claims or judgments of this kind caused by the negligence of the railroad company while it operated the road are regarded quite generally as unsecured claims against the road, and are not paid by the receiver out of his income, except in those few States where statutes give judgments of this nature a preference. See *Claims and judgments for injuries to persons or property.* Page 260.

When the income in the hands of the receiver has paid all the expenses of the receivership and such other claims as may be specifically charged against it, then the balance, if any, goes to the holders of the bonds under the foreclosed mortgage and the other creditors according to their respective rights.

Distribution of income and proceeds of mortgaged property when trustee takes possession, operates, or sells.

The trustee may take possession of the mortgaged property upon default of the railroad company, when such power is granted him in the mortgage. Coupled with this power to take possession, he is also

usually authorized to operate the road. See *Possession and operation of the mortgaged road by the trustee, etc.* Page 154.

The income that the trustee earns while operating the road, and such income as he may have received from the railroad company, together with the proceeds of the mortgaged property, by sale, lease, or in the case of stocks and bonds, as dividends or interest, are distributed by him in the manner that the mortgage points out.

The trustee has no authority to take possession of the road or to operate it or to sell it unless the mortgage gives him that power; and this same mortgage that authorizes him to do so also regulates how the moneys received or realized as a result of the exercise of such power shall be distributed.

The moneys received by the trustee, from all sources under the mortgage, are usually ordered distributed by the mortgage so that they shall be applied first to the payment of the expenses of the sale and of the trusteeship, which shall include all necessary expenditures, covering also his own compensation and that of his legal counsel; then to those claims that the statutes or the courts give preference to; after these, to the payment of mortgages or other liens having priority over his mortgage. When the property is sold free and clear of such prior mortgages or other liens, the full purchase price is actually paid and such prior mortgages or other liens are

then first paid in full out of, or their lien transferred to, the purchase price so paid.

When the property is sold subject to such prior mortgages and other liens, their amounts are taken into consideration when the actual amount of the purchase price is to be paid, and the actual cash or other payment is reduced accordingly. Then the purchaser must satisfy these prior mortgages or other liens himself, only, however, to the extent that the property purchased will do so. His liability is not a personal one; the property rather than the purchaser is liable. Should that property be insufficient to meet such demands in full, then the purchaser is not liable for such deficiency, but for such unpaid balance these mortgagees and lienors are creditors of the railroad company. Sometimes, however, usually in reorganization proceedings, the purchaser may assume the payment of the claims secured by such mortgages and other liens subject to which the property was purchased; then such purchaser, having assumed these debts secured by such mortgages or other liens, is personally liable notwithstanding that the property is insufficient to pay them.

Should the property be sold free from all prior liens and mortgages, and the trustee has paid all such claims, so secured, in full, then he applies the balance to the satisfaction of the bonds and coupons or claims for interest under his mortgage. He usually pays such principal and interest, with interest on

overdue interest, without preference to either principal or interest. Should there be insufficient to pay principal and interest in full, then they share proportionately, on an equal basis. The order of distribution just given is that most common, though some mortgages may make other arrangements as to payment of principal and interest, or the priorities between them; but the mortgage cannot disturb or affect the rights or priorities to which others who are not parties to such an arrangement are entitled. See *Priorities, if any, between principal and interest.* Page 92. See also *Priorities among interest coupons and claims for interest.* Page 260.

Creditors of the railroad generally; what is meant by priority.

The average railroad company consists of a number of branch lines operated as a system.

Upon insolvency it will be found that its property is encumbered by a number of mortgages and other liens of different kinds and legal ranks; there will be claims that are given a preference in payment out of the assets of the road, either by law or by order of the court; and there will be found those creditors who have no security or preference.

To ascertain the rights of whomsoever may claim any interest in the property of the railroad company, or against the road, and determine their relative priorities, is the task that confronts the court at this time.

Among the creditors having mortgages or other liens there may be found the holders of bonds secured by the underlying liens placed by constituent companies on the branch lines they owned before consolidation; also first, second, general or blanket mortgages on the entire system. Collateral trust bonds may have been issued by the parent company, to secure which are pledged stocks and bonds from its own treasury or the stocks and bonds of its subsidiary companies. Car trust certificates or equipment bonds may be outstanding covering the equipment of the road. The terminals may have been mortgaged to secure an issue of terminal bonds. Some of the creditors may have reduced their claims to judgment, they are then secured by the lien of their judgments. The interest on preferred stock may have been made a lien on the property of the corporation or some of it. The claims under purchase money mortgages must be considered. Claims for labor or materials furnished, under some conditions, are entitled to a preference under the law of some of the States. Claims or judgments for injuries to persons or property caused in the operation of the road by the company are given a preference under the law of some of the States. Mechanics' liens may be charged against the property of the road. The claims for operating expenses, preferred by order of the court, and the lien that the court gives receiver's certificates are matters for consideration. And,

too, the claims for unpaid taxes and other governmental charges, and for the expenses of the receivership and of the trusteeship, are to be taken into account, as they are given a priority over the other indebtednesses of the road. And in addition to the relative rights of these secured creditors of different kinds and ranks, there will be found the general or unsecured creditors, including perhaps the holders of notes or debentures of the insolvent road.

To the discussion of the respective priorities of these different classes of creditors, and their rights in the assets of the insolvent road, this chapter is addressed.

By priority in payment out of certain property is meant the right to receive payment in full out of that property before those following next in rank receive anything from it.

The right to priority in payment out of certain property depends upon a mortgage or other lien against that specific property in favor of the creditor claiming such priority.

Priority among several mortgages or other liens depends, generally speaking, upon the time when they attached to the property. A mortgage or other lien usually attaches to property at the time when the document granting it is recorded in the office of the public officer designated by law for that purpose.

The rights of bondholders and all others secured by mortgage or other lien, relates back to the time

when the instrument granting the lien was recorded. Nothing that the railroad company can do in the way of incumbering the property after that can affect the security that such mortgage or other lien gives.

There are some claims, however, that, by reason of their nature, are given priorities and are sometimes preferred over some liens already existing. Receivers' certificates and sometimes claims for operating expenses come under this heading. Taxes, public assessments, and other governmental charges are always preferred and paid before all other liens and claims.

Creditors having a prior lien may waive it in favor of those having a later lien; this is sometimes done in the reorganization or readjustment of the road.

Claims of employees of the road for services rendered prior to the receivership in most States are given a preference. And where such statutory preference is not given, and they are not to be included under the head of operating expenses, they are usually paid by the receiver upon consent as a necessary expedient in continuing the road in operation as he depends upon their services and skill; and those who purchase the road at foreclosure, or reorganize it, also do so on the ground that they have the advantage of a fully equipped complement of employees to take care of the management and details of the road. Quite generally when the claims of employees are for the physical labor necessary to

maintain and operate the road, for the six months or any part thereof prior to the receivership, they may be given a preference. See *Operating expenses prior to receivership, etc.* Page 245.

Creditors on equal footing.

Between creditors of equal standing, the established rule universally applied by the courts is that distribution shall be made proportionately among them. Their rights are equal and each shares proportionately in the fund to be distributed among them as a class.

Should there be insufficient to pay all in any one class, then each of that class bears the loss proportionately.

Successive mortgages or other liens; waiving priorities.

As between bondholders or other creditors secured by successive mortgages or other liens against the same property, the rule is that the mortgage recorded first shall be entitled to priority and the claims under it shall be paid first, in full, out of that property before the claims under the mortgages or other liens succeeding it shall receive anything. As to other property of the road upon which they have no lien they stand on an equal footing.

The railroad company has no power to give to a later mortgage, no matter for what purpose, any

rights that can supplant or displace the lien of a prior mortgage.

The bondholders under a prior mortgage, however, may consent to waive their priority in favor of a subsequent one. This is sometimes done in adjusting the affairs of an insolvent railroad company. These bondholders may believe that the financial embarrassments of the company will be met and overcome with some assistance and, therefore, do not enforce their mortgage, though they have the right to do so, but consent to give priority to a later mortgage to secure an issue of bonds or notes that will raise money to relieve the road from what apparently is a temporary stress. See *Prior lien bonds; preferential bonds.* Page 326.

Only those bondholders under the prior mortgage who consent will be affected. Those who do not consent will retain their priority. It is a question of policy whether or not the bondholders will consent. The trustee under the mortgage has no power to bind a bondholder by his consent in this regard.

Closed mortgages; open end mortgages; bonds in series; open mortgages.

Railroad mortgages may be given to secure a specified or limited aggregate amount of bonds, all of which are put out at once. This is termed a closed mortgage. The holders of such bonds stand on an equal footing and share proportionately in the secur-

ity that such mortgage gives them in the absence of any special arrangement to the contrary.

An issue, however, may be for a specified limited aggregate amount but all the bonds may not be put out at once. The mortgage securing such an issue is called an "open end" mortgage, though technically it is a closed mortgage as the total aggregate amount is limited. The issue is for an amount somewhat larger than the present needs of the railroad company. Its object is to provide for present purposes and to avoid the necessity of another mortgage when more money is needed in the near future, as, for instance, to retire underlying securities or to meet future requirements of the road. The bonds are then put out in series, under the terms of the mortgage, to meet the needs of financing or equipment as they arise. Usually bonds for a certain amount are put out on the execution and delivery of the mortgage; and upon a specified later date, or at the request of the board of directors of the road, or at such other times or upon such other happenings or events as the mortgage shall provide, another series in a fixed sum is put out and so on until the entire issue is negotiated. All fall due at the same time.

In the absence of any provision in the mortgage to the contrary, all the bonds of such an issue stand upon the same footing without regard to when they were put out or negotiated. The mortgage, however, may provide that bonds of one series shall have

priority over those of another. As a quite general rule there is no distinction made.

Bonds of an issue of this kind are to be distinguished from "serial bonds," as they are usually called, which are issued under a mortgage which provides that each series shall fall due at different times, each running for a specified period. See *Numbered bonds.* Page 241.

Where a mortgage is made by a railroad company on its property to secure bonds, but there is no amount specified or limited, the company may issue as many bonds as it desires, its only limitation being that put on it by the statutes that exist in most States by which railroad companies shall not have outstanding at any one time a bonded indebtedness beyond a certain proportion of its authorized capital stock, its paid in capital stock, or its property, as the case may be. Mortgages that contain no limitation as to the aggregate amount are called "open mortgages." They are rare.

Numbered bonds.

Railroad bonds are usually numbered.

When numbered bonds bear the same date and are alike except as to the numbers, it is presumed that they are numbered not for the purpose of giving one number any priority over another, but merely for convenience in registration and to aid identification. There is then no distinction between them and they

all stand on the same footing and each is entitled to its proportionate share and rights in the security.

In issues of railroad bonds, numbers are often given a significance and form part of the contract between the railroad company and the bondholder. This is where the issue is divided into classes and distinguished by numbers and sometimes by letters, and one class is given certain rights and preferences that the others do not enjoy. Under such an arrangement the bonds distinguished by a certain letter, or those between certain numbers, may be redeemable and called in before the others, or they may have certain rights and privileges that the others have not.

Notwithstanding these special rights and privileges that they may possess or those obligations they may be subject to, if there be nothing in the mortgage to the contrary, these bonds are all of equal standing, all equally secured by the mortgage, and all are entitled to share proportionately in the security. When serial bonds, or bonds subject to calling in, are called in under the provision to that effect in the mortgage, it is usually there provided that after the date on which they should be surrendered or fall due, they shall thereafter no longer be secured by the mortgage, nor draw interest from such due date. See *Payment of serial bonds; bonds issued in series*. Page 100. See also *Redeeming bonds or calling bonds in*. Page 98.

Serial bonds are to be distinguished from bonds

issued in series. The terms are not always accurately employed. In the case of bonds issued in series, they all fall due on the same date, though they are put out at different times; in the case of serial bonds, they are all put out at the same time, or at such times as the mortgage shall provide, but they fall due in series at certain specified times, each series running for a different period.

Over-issued bonds.

Railroad bonds are sometimes issued in excess of the amount to which the issue is limited. The over-issued bonds are good in the hands of a bona fide holder who has paid value and bought them in the usual course of business before their maturity, in good faith, and without notice or knowledge that there was anything wrong. A bondholder meeting all these requirements is entitled to have his bonds, though over-issued, share proportionately in the security of the mortgage.

Over-issued bonds are void in the hands of one who is not a bona fide purchaser, as just described. See *Validity of bonds.* Page 18. See also *Trustee's certificate.* Page 70.

Re-issued bonds; exchanged bonds; substituted bonds.

Unless forbidden by its charter or by law, a railroad company may buy in its own bonds and re-

issue them. Such bonds when re-issued possess the same rights under the mortgage that they had before the railroad company acquired and put them out again.

Sometimes in the adjustment of the affairs of a railroad company, the bonds of an issue secured by a mortgage may be exchanged for bonds of a new issue. The question may then present itself: Are the new bonds secured by that mortgage?

This depends entirely upon the intention of the parties when the exchange was made as shown by the facts and circumstances surrounding the transaction. If it was intended that the whole debt secured by the mortgage should continue, then the transaction is merely a substitution of the new bonds for the old ones, and the new bonds are entitled to all the rights under the mortgage that the original bonds had. The mortgage continues to secure the old debt which has now taken a new form. However, if the intention was that the debt evidenced by the old bonds was to be extinguished, and the new bonds were issued not in exchange but in payment of them, then the original mortgage does not secure such new bonds. The instances discussed are those where one *issue* is exchanged for another, and do not have reference to the exchanging of a coupon bond for a registered bond, or *vice versa*, as is usually permitted. They are of the *same* issue.

New mortgage before all bonds under prior mortgage are put out.

Before all the bonds secured by a railroad mortgage are put out, a new issue may be made and be secured by a mortgage which is a later lien. All the bonds under the first mortgage are entitled to the protection of its lien, no matter when they were put out or negotiated, in the absence of any understanding to the contrary; and as its lien is prior to that of the later mortgage, the holders of the bonds of such first issue, who receive their bonds before their maturity, though after the execution and recording of the later mortgage, are entitled to priority over the holders of the later issue.

The later issue does not operate to retire the bonds of the prior issue not yet put out. The holders of the bonds of the later issue might have protected themselves as against the bonds of the prior issue not yet put out, by demanding that they be destroyed before their issue is negotiated.

Operating expenses prior to receivership; nature of claims entitled to this preference; six months' rule; extent of preference; reasons therefor; funds affected by the preference.

It is well settled in this country that the claims for operating expenses incurred by the railroad company before the receivership may be given a preference over the claims of the other creditors of the rail-

road company, with regard to the income of the road and perhaps the mortgaged property itself.

They are paid in full out of the income in the hands of the receiver before the bondholders under the foreclosed mortgage or other creditors receive anything. And should the income earned by the company have been diverted from the payment of current expenses to the improvement of the mortgaged property, then the operating expenses are given the same preference with respect to the proceeds of the sale of the property itself, to the extent of the moneys so diverted.

Generally speaking, the claims for operating expenses that come under this rule are those for services rendered or materials furnished to the railroad, and necessary for its maintenance and operation, within six months prior to the receivership.

This rule has been molded by the necessities of the complex situation that confronts the court in adjusting the affairs of the insolvent railroad company. It finds its justification on the grounds of equity and public policy.

It is not lightly that the court will displace the lien of the bondholders in favor of claims for operating expenses, and the tendency, therefore, is to give the term a narrow application. Accordingly, claims for services in order to come under the rule are limited to those of operatives and employees engaged in the manual labor of running the road or making repairs

on it. A distinction is drawn against the services of a financial or executive officer who may be regarded as an employer in operating the road. Only those who actually do the physical work are entitled to this preference; and the claims for services of those acting in a supervisory capacity, though employees of the company, are not classed as operating expenses.

Claims for materials furnished are governed by substantially the same rule. To come within the rule, the materials furnished must have been indispensable in making repairs necessary for the maintenance and operation of the road or its equipment.

After complying with these requirements as to the nature of the work or the kind of materials, it is necessary too that they should have been rendered or should have been supplied within six months prior to the receivership. The court may fix this period at more or less than six months. Its action is based upon the conditions that confront it. As a general rule six months is specified.

The theory upon which the court works out the equity of the preference is that had the road continued in operation it would have paid these operating expenses from its earnings; but having withheld them, those entitled thereto may follow and claim them.

Current income should be applied to current expenses. The bondholders should have received only the net income, what is left after these expenses are

paid, in payment of their interest. Railroad companies usually get their labor, supplies, equipment and improvements on credits of varying periods, and when it becomes financially embarrassed these debts are allowed to accumulate for a period, usually, of about six months prior to the receivership, and the earnings of the road during that time, which should have been applied to their payment, is usually used to pay interest on bonds to prevent or postpone a foreclosure or other legal action. These earnings for that period should not be used for interest on bonds until all the current expenses of that period are paid in full.

The rule, too, finds its vindication on grounds of public policy. The rights of bondholders under railroad mortgages involve considerations that are peculiar to that class of securities and which do not enter into the case of bonds secured by mortgage on other property. This results from the fact that a railroad company, though an association of private individuals organized for private gain, is, in its relation to the public, a quasi public corporation. The public is concerned with the franchise of a railroad company and vitally and immediately interested that it shall be continued in operation. And all persons who become holders of railroad bonds are held to have accepted them and otherwise to have dealt with the corporation with the implied consent that should it fall into insolvency and its affairs be administered

by the courts, then those debts necessarily incurred for the purpose of continuing the road in operation and carrying out the objects for which the company was created, may be given priority over their own claims.

This priority is limited, ordinarily, to the income in the hands of the receiver; but, where the income of the road prior to, or during, the receivership has been used to improve the mortgaged property, then claims for operating expenses are charged against the mortgaged property thus improved, to the extent of the income that was used to pay for such improvements. Under these circumstances, operating expenses to the extent of the amount that has been thus diverted are ordered paid out of the proceeds of the mortgaged property before the bondholders or other creditors receive anything therefrom. It must be shown that the income was diverted to the improvement of the mortgaged property and from the payment of the current expenses, before such property itself will be charged with their payment, otherwise the preference in favor of operating expenses is limited to the income. Should there be no income and no diversion, then claims for operating expenses prior to the receivership have no preference and are paid like general or unsecured creditors, unless they are otherwise secured or preferred.

Claims against the receiver for services rendered or materials furnished during the receivership are

differently considered; they are regarded as expenses of the receivership and, as such, are paid in full before the bondholders or other creditors receive anything.

In many of the states there are statutes to the effect that claims for labor performed and for materials furnished to the railroad company necessary to construct, alter or repair the road shall be entitled to a lien on the property of the railroad company, so affected, and shall be entitled to a preference over any mortgage covering the same property given subsequent to the time when the lien attached protecting such work or materials furnished. See *Mechanics' liens.* Page 252.

Claims for original construction.

Bondholders are entitled to be paid in full out of the proceeds of the property that has been mortgaged to them before the claims of those who built the road, either before or after their mortgage was given, receive anything; unless the claims for such original construction are protected by mortgage or other lien. Should such claim be protected by mortgage or lien it then becomes a question of the priority of the respective liens. See *What is meant by priority.* Page 236.

Experience has shown that public and private interests demand that in the building of a railroad the moneys for that purpose shall be fully and ade-

quately provided for before the commencement of the work. Obligated to the State to serve the public, the railroad company may not permit its property and franchise to lie dormant in disuse. It must go forward with the enterprise in the reasonable expectation of being able to pay the mortgage and costs of construction and realize to the public and to itself the legitimate benefits of the undertaking. If money be not raised by the sale of bonds, the enterprise would stop immediately, and the labor and materials already furnished would lose their greater value and the opportunity to earn the money to pay for them would also go. If the bondholders do not advance their money at this critical time, all that had been done would greatly diminish in value if not be lost.

And the efforts that have been made to obtain for the claims for original construction of the road a preference, because they furnished by their labor and materials the very property which is mortgaged to the bondholders, finds no foundation.

Those supplying the materials and labor for the original construction of the road might protect themselves by a mortgage: but the presence of a mortgage to secure the claims for original construction would interfere with later and necessary financing. And it seems no hardship that the claims for original construction of the mortgaged property should be paid out of that property after the claims of the bondholders secured by mortgage on it, as it is the money

the latter supply that makes the labor and materials of the former productive and of practical value.

In some of the States, however, there are statutes that give contractors and those supplying materials and labor for the original construction of a railroad a preference in payment out of the assets of the corporation over a mortgage upon the road executed later.

Sometimes the claims for original construction of the road, or for permanent repairs, may take the form of claims for operating expenses and, as such, receive a preference. See *Operating expenses.* Page 245.

Mechanics' liens.

As a rule, mechanics' liens do not affect railroad property unless the statute giving the lien specifically declares that it shall include railroad property.

A lien is sometimes given by statute to those who furnish materials or render labor in the constructing, repairing or altering of the property of a railroad. These statutes declare that within a limited time, usually ninety days, after the last item of work has been done or piece of material has been furnished, a written statement of the claim must be filed in the office of the public officer designated, usually the clerk of the county where the property is situated upon which the lien is claimed.

From the time this statement is filed the lien attaches to the property that was benefited by the labor or materials, and such lien takes priority over any

mortgage or other lien subsequently attaching to the property. However, as was stated, a mechanics' lien does not apply to the property of a railroad unless the statute which gives the lien says that it shall.

Attachments and executions against property of the road.

As a railroad is charged with its duty to the public to continue in operation, an attachment or execution may not be levied against such of its property, or under such conditions as will interfere with the performance of such public duties; a receiver will then be appointed. An attachment or execution, however, may be levied against the property of a railroad where it does not interfere with its operation. See *Judgments*. Page 258.

An attachment against property is the legal process whereby property of a party to the suit, at the instance of the opposing party, is taken during the progress of civil litigation, and is held to await the final determination of the rights of the parties. Should the party at whose instance such property was seized be successful in such suit, he may then take such property so attached and apply it to the payment of the judgment he has obtained. It is a means of seizing property, at the commencement of litigation, to insure payment of a judgment and also so that its owner cannot remove or dispose of it, and thus defeat subsequent proceedings against it.

Should the party at whose instance such property was attached be defeated in the final outcome of the suit he must pay the owner of such property damages for its wrongful seizure and detention.

An execution against property is the final process in a civil suit whereby the property of the defeated party is taken by the officer designated by law for that purpose, usually the sheriff, to satisfy the judgment that has been rendered in favor of the successful party.

Preferred stock.

The claims of bondholders under a mortgage are prior, ordinarily, to those of the holders of preferred stock, for both principal and interest. However, preferred stock may be issued under an agreement that the dividends payable on it shall be a charge against the property of the road, prior to all indebtednesses subsequently created. In such a case, a mortgage executed by the railroad company, after such an agreement is of record, is subordinate or junior to the claims for such dividends so secured.

Taxes, public assessments, governmental charges.

The lien of the bondholders under their mortgage and the claims of all other creditors are, as a general rule, deferred to the indebtednesses of the corporation for unpaid taxes, public assessments, or other governmental charges. Money due for the pur-

poses mentioned are declared by statute to be liens upon the property of the person or corporation owing it. The superior standing of indebtednesses of this character is always recognized by the courts and they are paid in full, no matter when they accrued, before any other creditors receive anything.

The lien for claims of the kind under discussion do not displace the lien of the mortgage of the bondholders, unless the statute imposing such tax, or other enactment, declares it shall; these statutes invariably declare, however, that the liens for charges of the nature mentioned shall be superior to all other liens against the property.

Purchase money mortgages; conditional sales.

The mortgage that the railroad company may execute to secure the unpaid balance of the purchase price of property that it may acquire, is superior to any mortgage or other lien that the railroad company may execute or create, or may have executed or created against such property, either before or after such purchase money mortgage was given.

Therefore, property falling under the lien of a mortgage already existing against the road with the after acquired property clause, must first satisfy in full a purchase money mortgage before its proceeds shall be applied to the satisfaction of the claims under such mortgage with the after acquired property clause.

The theory of law upon which this conclusion is reached is that the railroad company never was possessed of that portion of the property covered by the purchase money mortgage; and the railroad company gets this property subject to such purchase money mortgage; it has attached to the property before the railroad company got it, and whatever it may have done or may do in the future is subject to such purchase money mortgage.

A similar result is produced by the arrangement known as the "conditional sale."

Property may be sold to the railroad company with the condition that the party selling it shall retain the title and ownership until the purchase price has been paid in full, but that the railroad company may, in the meantime, have possession and use of the property. This is a conditional sale in which the passing of title and ownership are conditional upon the payment of the full purchase price.

As the corporation can mortgage only those interests in property that it has, its mortgage does not include such property purchased on conditional sales, as it has no interest in that property, such as can be the subject of a mortgage, until it has paid the purchase price in full and acquires title. Should there be an after acquired property clause in the mortgage, it covers such property only when the railroad ultimately acquires the title to it. See *Car trust certificates or bonds*. Page 316.

The difference between the two instances is that in the purchase money mortgage the railroad company acquires the title and ownership of the property immediately, subject to the superior lien of the purchase money mortgage; while in the conditional sale the title and ownership to the property continues in the seller until the full purchase price is paid, though the railroad company may have possession and use of it in the meanwhile.

Right of way claims.

Land may be taken from owners against their wills for public purposes. As railroads are regarded as quasi public corporations, land may be taken thus for rights of way for railroads.

The right to take land under these circumstances lies in the State by reason of its sovereign power. This is called the "right of eminent domain." The value of the land so taken is appraised and such sum paid to the owner. He and his experts have an opportunity to be heard. The proceedings under which the land is thus taken, and its value fixed and paid, are called "condemnation proceedings."

Owners of adjacent land which has been harmfully affected by the road running near it, though such land has not been actually taken, are entitled to damages to the amount that the property has been diminished in value.

When a railroad includes a right of way in its

mortgage there may be a conflict as to priority between bondholders under that mortgage and those from whom the right of way was acquired.

Those from whom land for rights of way was acquired under these proceedings are entitled to a preference for the unpaid price, or any portion of it, over all mortgages of the railroad company. Claims for damages to adjoining owners against the railroad company arising out of the obtaining by it of a right of way, though their property was not actually taken, are given a like preference.

However, should the right of way be purchased with money that is loaned to the railroad company, the party loaning the money for that purpose is not entitled to any preference. His relation is that of one who has loaned money to the company and not that of one from whom the right of way was acquired.

Judgments.

The claims of the bondholders under their mortgage are entitled to payment in full out of the mortgaged property before judgments against the road receive anything from that property, where the judgments were recovered and docketed after the mortgage was recorded or filed. If the judgment was docketed before the mortgage was recorded, then it is entitled to be paid in full out of the property of the road, including the mortgaged property, before the

bondholders receive anything from the property covered by their mortgage.

Whether the mortgage or the judgment has priority in payment out of the proceeds of certain property depends upon which was made a public record first, by filing or recording in the case of the mortgage, or docketing in the case of the judgment.

The docketing of a judgment in the office of the public official designated therefor, usually the clerk of the county wherein the judgment was obtained, makes that judgment a lien against the real estate of the railroad company situated within that county. Transcripts of the judgment may be docketed in each county in which the railroad company has property, and thus become liens against its property in each of such counties.

Both the docketed judgment and the filed or recorded mortgage create liens against the real estate of the railroad company. The lien of the judgment attaches to all the real estate of the corporation situated in the counties in which the judgment is docketed; while the lien of the mortgage attaches only to the property that is pledged by the mortgage. See *Attachments and Executions.* Page 253.

Claims and judgments growing out of injuries caused persons or property while the receiver operated the road are regarded as expenses of the receivership and therefore are paid in full before the claims under any mortgage receive anything.

Claims and judgments for injuries to persons or property.

All claims for damages arising out of the transportation of persons or property while the railroad company operated the road are, as a general rule, classed as general or unsecured debts of the road.

In a few States judgments for damages to persons or property sustained while the railroad company operated the road, constitute a lien on all its property, from the time the injury was inflicted, and are entitled to be paid in full out of such property, including that covered by mortgages, before the bondholders under such mortgages receive anything. In the absence of such a statute law this right to a preference does not exist.

Claims or judgments against the receiver, however, for injuries or damages to persons or property during the operation of the road by him stand upon a different footing and are paid as expenses of the receivership, and are paid therefore in full before the bondholders under their mortgage receive anything.

Priorities among interest coupons and claims for interest; between principal and interest.

Interest coupons or claims for interest are, ordinarily, not entitled to priority over the principal of the bonds. Nor are interest coupons or claims for interest, as among themselves, entitled to any preference because one matures before the other. How-

ever, overdue coupons have been given a preference over their bonds which have not matured, when a part of the series of coupons to which they belong had already been paid.

Railroad mortgages usually provide that all interest coupons and claims for interest shall, under all circumstances, share equally in the proceeds of the mortgaged property; and that when the principal of the bonds becomes due (for any reason) that the coupons and the claims for interest and the claims for the principal of the bonds shall all stand on the same footing and be paid without preference of one over the other. However, railroad mortgages may properly make provision for a priority among the coupons and principal and, as is sometimes the case, declare that coupons shall be entitled to a priority according to the dates of their maturities. Sometimes a railroad mortgage will contain a provision that the coupons shall be paid before the principal of the bond. Such arrangements or any other that the parties shall agree upon will be carried out by the court.

The usual form of railroad mortgage contains the stipulation that when the coupons are paid they shall be canceled. This is done because a third party may have advanced the money to the railroad company with which to pay the coupons and may then hold them against the railroad company as its unpaid outstanding obligations. To permit such third party

to keep alive these coupons would enable him to prove them in competition with the holders of the bonds and of the other coupons under the mortgage and to share with them in the security, and thereby lessen their respective shares in the proceeds of the mortgaged property. Hence this provision that when paid, the coupons shall be canceled so far as the holders of the bonds and other coupons are concerned. But as between the railroad company and the party paying off such coupons in its behalf, the coupons may be kept alive as evidence of the debt the railroad company owes such third party for the money so advanced. See *Effect of payment on coupons.* Page 38.

Notes; debentures or unsecured bonds.

When a railroad company has the power to issue written obligations for the payment of its debts, the particular form such obligation shall take is a matter that the corporation itself may regulate. It may issue bonds or notes, and may or may not secure them by mortgage or otherwise.

A note is the written promise of the railroad company to pay a certain principal sum with the date of payment, rate of interest, and the times for the payment of the interest specified in the note. The notes may be in coupon form and may have coupons attached, the same as bonds have, for the different instalments of interest. The same rules in all re-

spects apply to the principal and coupons of notes that apply to the principal and coupons of bonds.

There is no difference between a note and a bond in their respective natures, as each is the written promise of the issuing company to pay according to the tenor of their respective terms; nor is there any difference between the coupons of each, in their respective natures. See *Notes and bonds compared*. Page 11.

Notes of a railroad company may be secured by a mortgage on its property, or they may be otherwise secured. The same rules apply to the mortgages or other security for notes as apply to mortgages or other security for bonds under like conditions. It seems the custom, however, to issue notes without security of any kind other than the credit and standing of the issuing company, and its general ownership of property, without creating any specific lien thereon in favor of the notes.

Notes are usually issued for shorter periods than bonds. When they are issued for longer periods and are not secured they are referred to as debentures.

In the United States, the term "debenture" is generally used to designate a bond that is unsecured by mortgage or any collateral. It is a plain bond containing a promise by the railroad company that issues it to pay a specified sum with interest, at a certain date.

The term as used in the United States should not

be confused with the meaning given to it in other countries.[1] In the United States a debenture is generally understood to mean an unsecured bond.

The holder of an unsecured note or an unsecured debenture of a railroad company stands upon the same footing as any other general or unsecured creditor of the corporation. He shares proportionately with all other general or unsecured creditors in the property upon which there is no mortgage or other lien. He has no recourse to any property of the railroad company that is covered by a mortgage or other lien, until all the claims represented by such mortgages or other liens have been satisfied in full out of such property. He then shares proportionately in what remains of such property after such mortgages or other liens have been satisfied in full.

Should the bondholders or other creditors secured by mortgages or other liens against specific pieces of property find that after such property has been realized upon there is a deficit, then for such balance of their claims remaining unpaid, they become general or unsecured creditors and, as such, are entitled to share proportionately with the unsecured debenture holders and unsecured noteholders and all other unsecured creditors in such funds as the latter class of creditors have access to. See *Secured and unsecured creditors.* Page 227. See also *Difference between bondholders and stockholders.* Page 15.

[1] See footnote, pages 11 and 12.

Debenture holders and unsecured noteholders are entitled to be paid in full before the stockholders receive anything.

In many issues of debenture bonds and of notes that are unsecured, the railroad company stipulates that it will create no mortgage or other lien on its property to secure any subsequent issue of bonds or other securities that will give such subsequent issue priority over or equality with the holders of such debentures or notes. Sometimes the provision is that, should a mortgage be subsequently given to secure a later issue of securities, the holders of such notes or debentures shall share in the security such mortgage gives equally with the holders of the securities issued under it.

The standing of the debentures and of the notes and of the property of the road is not disturbed but is thus kept as it was when such notes or debentures were issued; in this way the debentures or notes are not subsequently mortgaged out of the equity in the property of the railroad company that they had at the time they were issued.

As was said, debentures and notes are usually put out for shorter periods than secured bonds; they are also usually put out for smaller amounts than the usual issue of secured bonds, thus saving the expense and trouble of mortgaging the property of the road for temporary purposes. They are usually taken up by later issues of refunding or general mortgages

bonds. See *Unification; general mortgage bonds; blanket mortgage bonds.* Page 269. See also *Refunding mortgage bonds.* Page 272.

First lien bonds.

First lien bonds are secured by a lien upon the mortgaged property that is prior to all other mortgages or other liens. They are secured by a mortgage that is a *first* lien upon the property it covers.

First lien bonds are satisfied out of the property covered by their mortgage, in full, before any other claimant is paid; except such debts as are preferred by the statutes of the States, such as claims for taxes and other governmental charges; and also such debts that the court gives a preference to, such as claims for operating expenses and receivers' certificates.

To be first lien bonds they must be secured by a mortgage that is a first lien on the property it covers; there must be no prior mortgage or other prior lien, created by the railroad company or by a constituent company before consolidation, against the property pledged by such prior lien mortgage.

A mortgage that is strictly a first lien mortgage usually contains a representation and promise by the railroad company issuing it that the property it pledges is subject to no mortgage or other lien and that it, the railroad company, will not create or suffer to be created any lien that shall have priority over or equality with the lien of that mortgage; and with

respect to such liens as may be given a preference, that it will discharge or adequately provide for them.

Attention may be here called to the fact that an issue of bonds may be termed "first lien" bonds because it is secured by a first lien on part of the property that the mortgage covers, though it may be an inferior and junior lien on the other parts.

First mortgage bonds; first mortgage trust bonds; first mortgage consolidated bonds; second, third, etc., mortgage bonds.

The term "first mortgage" bonds, as used in modern finance, may not mean that they are secured by a mortgage that is a first lien on all the property covered by the mortgage; it may not be a lien on the physical property of the issuing company at all.

The so called first mortgage may be a first mortgage or a first lien only on a division of the mortgaged road or only on a portion of the property it covers, and as to the other divisions or property it covers, it may be a lien later, inferior, and junior to other mortgages or other liens existing against it.

Sometimes a mortgage is called "first" when it is not a lien on the road or the physical property of the issuing company, but because such mortgage covers bonds or other securities issued by another railroad company and deposited with the trustee, which deposited securities are secured by a first mortgage of some kind on the property of that other railroad

company. When there is a default under the mortgage securing the deposited bonds, the trustee proceeds to foreclose that mortgage and to realize on the securities that have been deposited. And it is the duty of the trustee to keep under observation the company that issued the deposited securities.

Bonds secured by securities deposited in trust, and which deposited securities are secured by a first mortgage on the property of the company that issued them, are usually called "first mortgage trust" bonds. See *Collateral Trust Bonds.* Page 277.

In a further attempt at analysis, the *first mortgage consolidated bonds* may be fruitful. The term "first mortgage consolidated" bonds may be taken to mean an issue, that while they may be secured by a first mortgage upon all the property owned in the name of the consolidated company that issued them, they are nevertheless subject to such prior mortgages or other liens as the constituent companies, that formed the consolidated company, may have placed against such property before the consolidation or merger. When mortgage bonds are issued by a consolidated company it is notice to the intending bondholder that they may be secured by a mortgage upon property that may have been derived from two or more constituent companies, and that they are therefore subject to whatever mortgages or other liens that may have been placed on it prior to the consolidation or merger.

Second mortgages, or third mortgages, or mortgages other than first, are rarely used. When they are used they are entitled to priority in payment out of the property against which they are successive liens, in the order in which they attached to such property. See *Successive mortgages or other liens*. Page 238. It seems to be the custom when putting out an issue after a mortgage already exists against the property of the road, to make such later issue for a larger sum than is then needed and to secure it by a general mortgage or blanket mortgage, covering all the property of the issuing company, and with part of the proceeds to refund or to take up the bonds under such prior mortgages already existing. In this way the bonds of the later issue acquire in time the standing, rank or priority that such first or underlying issue, which is retired, had. See *Unification; general mortgage bonds; blanket mortgage bonds*. Page 269. See also *Refunding mortgage bonds*. Page 272.

Unification; general mortgage bonds; blanket mortgage bonds.

General mortgage bonds or blanket mortgage bonds are secured by a mortgage on all the property of the issuing company. They invariably follow some mortgage already on the property.

The general mortgage or blanket mortgage is subject, junior and inferior to all the mortgages or

other liens existing against the property mortgaged at the time it is executed.

There is a technical difference between a blanket mortgage and a general mortgage. It is that the blanket mortgage, properly named, covers several groups or systems of the road, each of which may have no relation to the other in its use; while a general mortgage, properly named, covers one road or a number of branches or divisions of the road, but all relating to each other in their use. This distinction is rarely observed, and the terms "blanket mortgage" and "general mortgage" are used interchangeably. Issues of the character of general or blanket mortgages are sometimes classified as unified bonds, as by their use the bonded indebtedness of the road is unified; thus simplifying its handling.

The general or blanket mortgage is usually for an amount large enough to meet the present requirements and future needs of the road, and also to refund or retire all or part of the bonds secured by prior or underlying mortgages or other liens. And as the paying off or retiring of the bonds of the underlying or prior mortgage progresses, the lien of the blanket or general mortgage advances, and when all the bonds of the prior or underlying mortgages are disposed of, the general or blanket mortgage then occupies the place that the mortgage so paid off enjoyed, which is usually a first lien upon the property it covers.

The blanket or general mortgage usually provides for putting out the issue in series or portions. The entire amount of the issue that has been authorized is not put out at once. A certain proportion is put out at the time of the execution of the mortgage; the next instalment is put out at a fixed time or upon the happening of a certain event or contingency; or instalments in fixed amounts may be put out when the railroad company, in its judgment, believes it necessary; or the different series or instalments may be put out when and in such amounts as the mortgage may provide. See *Refunding mortgage bonds.* Page 272.

No matter when put out all the bonds of the general or blanket mortgage are entitled to the same protection of their mortgage, in the absence of anything to the contrary contained in the mortgage. And all bonds under such an issue are entitled to priority over bonds or other securities secured by later mortgages, notwithstanding that the bonds under the general or blanket mortgage may have been put out after the later mortgage was executed. See *New mortgage before all bonds or notes under prior mortgage are put out.* Page 245.

Underlying liens.

An underlying lien usually represents the original mortgage placed upon the property.

When a consolidated company issues its consoli-

dated mortgage, it is subject to the liens of those underlying mortgages that were placed upon the property by the constituent companies before consolidation. See *Bonds of consolidated railroads; bonds of constituent roads.* Page 286. See *Divisional bonds.* Page 292.

Underlying liens precede and have priority over every later issue and are paid in full before such later mortgages or other liens receive anything out of that property. Underlying liens are usually followed, in time, by a refunding mortgage, or by a blanket or general mortgage with refunding features. Part of the money raised by these later issues is used for the purpose of retiring the bonds secured by the underlying liens.

In refunding plans, the underlying issues are retired by being paid for with the proceeds of the sale of the new bonds, or by exchanging them for the new bonds themselves; and when all the bonds secured by the underlying liens have been retired, their mortgage is canceled and the new refunding mortgage succeeds to its place as a lien.

Refunding mortgage bonds.

Refunding mortgage bonds are those intended to retire with their proceeds, or part thereof, or by exchanging, certain other bonds secured by prior or underlying mortgages or other liens against the same property.

At the time it is executed the lien of the mortgage that secures the refunding issue is, of course, inferior and junior to that of the mortgage that secures the underlying bonds; but as the refunding progresses, the lien of the refunding mortgage advances, and when all the bonds to be refunded have been disposed of, it succeeds, in effect, to the standing, priority and legal rank that the mortgage that secured the retired bonds enjoyed.

The refunding mortgage is usually for an amount that will retire the underlying liens, and that will also meet the present requirements of the issuing company and its future needs.

The mortgage contains the plan by which the prior issue shall be refunded.

The usual refunding plan is that all the bonds of the new issue shall be turned over to the trustee under the terms of the refunding mortgage; the trustee sells these new bonds and with the proceeds buys up the bonds secured by the underlying liens; or he exchanges the new bonds for them. In this way, when all the outstanding bonds secured by the underlying liens are taken up, by purchase or exchange, their mortgage is discharged of record and the mortgage securing the refunding issue takes its place.

During the time that the refunding goes on, the trustee, as he buys in or exchanges the old bonds, holds them uncanceled and in trust for his bondholders, so that, should there be a default under

the terms of the underlying mortgage, he will be in a position to enforce these old bonds under their underlying mortgage for the benefit of his bondholders of the new issue.

It should be noted that the lien of the mortgage securing the new issue succeeds to the lien of the mortgage of the old issue when the latter is discharged of record, provided that between the time when the old mortgage was recorded and the time when the refunding mortgage was recorded, no other lien attached to the property. Should a lien have attached in the meantime, it will take priority over the new refunding mortgage. But this is a matter of form only, because the trustee by holding the bonds of the old mortgage, uncanceled, is in a position to enforce them under the lien of the old mortgage and prior to the lien that may have come between, should it be necessary. The old mortgage will not be discharged should there be any intervening liens until they have been disposed of.

Bonds resulting from consolidation, merger, lease or control of property or stock of subsidiary companies.

The rapid growth of our country has brought about railroad consolidation. Under the old methods when railroad traffic requirements were small compared to those of to-day, small lines were operated successfully. They carried passengers and

freight between termini which were comparatively short distances apart. In time arrangements with connecting lines to act practically as extensions became necessary. These connecting or extending lines constituted in this way commercially, though not in the strict legal sense, one system. Each company was a distinct corporation; traffic contracts bound them commercially together.

The legislatures of the States through which these roads ran recognized the advantage and necessity of uniting the control of railroads under such conditions as existed, and enacted laws authorizing the consolidation of connecting or continuous lines. Then, as now, these statutes forbade consolidation of competing or parallel roads, thus preventing combinations between rival lines that would stifle healthy competition. There must be express authority for the consolidation, either by a general statute law or a special charter provision.

And so, in this way, systems of railroads were formed and later, by the consolidation or merger of these systems, the gigantic enterprises of to-day were brought about. And where consolidation or merger was not permitted, or was not feasible for any reason, the control of branch lines and of other railroads was acquired by the parent company of a great system owning the property or a controlling interest in the capital stock of such subsidiary company; or by lease of it; or by the personal element of the

same or friendly management; and in some instances through the means of the holding company.

The legislature of each State has the power to enact laws that will affect the persons and property only within its own geographical territory. The legislature of one State has no power to create a corporation in another State. The legislatures of two or more States cannot combine to form a corporation. The legislature of one State, however, may authorize a railroad organized under its laws to consolidate with one of another State. Should there be no authority for the consolidation or merger the same end is usually attained by the same persons acting as officers and the same directorate managing all the roads; or through the ownership of the property or controlling interest in or controlling voting power of the capital stock in one corporation by the other. Their affairs are then consolidated though the corporations are not. These different corporations in the different States may all use the same name; but each exists as a separate corporation. By any of these methods the policies of two or more railroads may be kept in harmony and serve each other's needs; and a system is thus formed.

The plan for controlling a railroad through the ownership of a controlling interest in its capital stock has developed the holding company. This is a separate corporation whose only purpose seems to be to hold controlling amounts or interests in the cap-

ital stocks of the various companies that form the system. It does not operate any road; but it manages all of them. It has a controlling vote in each corporation of the system, therefore, elects their respective boards of directors, decides the policies of each and by this consolidation of power, controls and is absolute master of the entire system. These holding companies are not favored in law when they tend to stifle competition. Recent legislation has been directed against them.

From the financing of these enterprises and the consolidation, merger, lease or control of the different railroads, there have resulted securities such as collateral trust bonds, consolidated bonds, underlying bonds of constituent companies, divisional bonds, guaranteed bonds, bonds of leased lines, assumed bonds, endorsed bonds, stamped bonds, terminal bonds, etc. To a consideration of the rights and remedies under these various forms of securities and their respective priorities, the following pages are directed.

Collateral trust bonds; collateral trust notes; convertible collateral trust bonds or notes; participating or profit sharing bonds; three methods of issuing collateral trust bonds.

Collateral trust bonds or notes are those secured by a mortgage under which the issuing company pledges securities belonging to it, such as stocks and

bonds, from its own treasury, or the securities issued by some subsidiary company that it controls. The physical property of its road is not mortgaged.

Collateral trust bonds or notes are usually issued by the parent company of a system depositing with the trustee under its mortgage the stocks or bonds, or both, of the minor or subsidiary road or roads it controls.

Under the collateral trust mortgage the securities that are pledged are deposited with the trustee.

When the deposit consists of different kinds of securities, such as railroad bonds, municipal bonds, stocks, etc., it is called "mixed collateral."

Should first mortgage bonds be deposited the issue is sometimes called "first mortgage collateral trust bonds." See *First mortgage bonds; first mortgage trust bonds.* Page 267.

Notes secured by a collateral trust mortgage are sometimes referred to as "mortgage trust notes," besides the more common designation of collateral trust notes.

Collateral trust mortgages may provide that the securities deposited with the trustee may be withdrawn, from time to time, by the railroad company issuing the mortgage, and others substituted in their stead. Such substitution can be made only on the consent of the trustee and under his supervision.

The power is sometimes conferred on the trustee by the mortgage to demand that the railroad com-

pany shall substitute new securities for such as, in his opinion, shall have diminished in value and are no longer an adequate security. The railroad company must comply with such demand within the time limited in the mortgage, and a failure to do so will be a default.

Where the mortgage provides for the substitution, converting, or changing of the securities, the issue is usually called "convertible collateral trust bonds."

The income from the pledged securities is also provided for in the mortgage. Usually the trustee receives it and pays the interest on the collateral trust bonds and with the surplus, if any, he maintains a sinking fund. The terms of the issue may be that the railroad company making the issue shall pay the interest on the collateral trust bonds directly, and accordingly shall receive the dividends and interest on the deposited securities.

The rate of interest payable on collateral trust bonds is usually at a fixed rate; however, it may be arranged in the mortgage that the rate of interest, while specified at a certain percentum, may be increased.

A provision of this kind is usually to the effect that should the deposited stock pay a dividend or dividends beyond a certain amount, the rate of interest on the collateral trust bonds shall be increased proportionately. When the mortgage contains such arrangement, the issue is known as collateral trust

bonds with the participating or profit sharing feature. This feature, however, is rarely employed.

Collateral trust bonds are usually issued for shorter periods than the usual form of railroad bonds, as they are issued at times when the interest rate is unfavorable to the road, or at a time when the condition of the market or of the credit of the issuing company may adversely influence their price. It is therefore to avoid the encumbering of the property of the road with a mortgage to secure an issue of bonds for a long period, put out at a higher rate of interest and at a lower price than would probably prevail in the near future, that collateral trust bonds or notes are sometimes issued. When conditions are more favorable an issue with a refunding feature may be put out and the collateral trust bonds or notes taken up.

Accordingly, the railroad company in issuing the collateral trust bonds or notes usually reserves the right to pay them off, in full or in part, before maturity. This, together with the privilege of converting or changing the deposited securities, gives the railroad company an opportunity to take advantage of the market and to dispose of any or all of the deposited securities that may be selling at a good price and with the proceeds pay off the collateral trust bonds which are usually issued at a higher rate of interest than other mortgage bonds.

The mortgage securing the collateral trust bonds

usually provides that the issuing railroad company shall not place upon the property of the subsidiary company, whose stocks and bonds are deposited under the mortgage, nor suffer to be placed thereon, any mortgage or other lien that will interfere with or prejudice, in any way, the rights and remedies of the holders of the collateral trust bonds.

The collateral trust mortgage creates no lien on the tangible property constituting the "road" of the issuing company, such as its real estate, rolling stock, and other property of kindred nature. In this it differs from the usual railroad mortgage which does create a direct lien on the tangible property of the issuing railroad company mentioned in the mortgage.

The collateral trust mortgage creates only an indirect lien on the property of the company whose securities are deposited, in that the lien of the collateral trust mortgage is upon the deposited securities only, though they, in turn, under their mortgage, are a direct lien (if mortgage bonds be deposited) upon the tangible property of the railroad company that issued them.

In order to realize on the collateral trust mortgage, its trustee, upon default of the issuing company, forecloses his mortgage against the deposited stocks and bonds or otherwise realizes upon them under any other remedies that the mortgage may give him, among them, selling them in the market.

The foreclosure of a collateral trust mortgage is more involved than that of the ordinary mortgage. The decree of foreclosure covers only the stocks and bonds pledged, and they pass to the trustee, under the decree, to be realized upon by him. He may sell them, if the court believes this advisable; or the court may declare that the trustee shall be regarded as the holder of such stocks and bonds and shall proceed against the property of the subsidiary company that issued such deposited securities, upon its default under its mortgage. The affairs of the subsidiary company and those of the parent company are usually so interlocked that the insolvency of the latter affects the former, and where the parent company is in difficulties and has defaulted, it will be found invariably that a like condition exists with regard to the subsidiary company.

And when the parent company has defaulted on its collateral trust bonds, the subsidiary company will be found to have defaulted on its securities that have been deposited. The trustee is then in a position to proceed against such deposited securities and in that way get at the physical property that was mortgaged to secure the deposited bonds of the subsidiary company; and where its stock has been deposited, to realize on the rights in its property, mortgaged or unencumbered, that such stock represents. To avoid the expense and delay that attends these separate foreclosures, the trustee is usually em-

powered by the mortgage to enter into possession of the property that was mortgaged to secure the deposited bonds and sell the same.

While railroad companies may issue collateral trust bonds or notes and secure them by a mortgage against stocks and bonds which it deposits with the trustee, taking such stocks and bonds from its own treasury, this form of bond and mortgage is more commonly used to raise money to build an extension or branch line which is or will become a subsidiary company.

The new division, extension, or branch line, by whatever name it may be referred to, is always incorporated as a separate and distinct legal body.

There are three methods of financing employed when raising funds for the subsidiary company, in which the collateral trust bond and mortgage is used.

(1) The parent company may supply the necessary money to the subsidiary company for the construction of the extension or branch, by buying its capital stock and its bonds which it issues, or a controlling interest in them. The parent company then reimburses itself by selling its own issue of collateral trust bonds, its own direct obligation, securing them by depositing the stocks and bonds of the newly incorporated branch line, which it has purchased. In this case the parent company pays cash for the stock and bonds of the subsidiary company and then reim-

burses itself by the sale of its own collateral trust bonds. This method means the withdrawal from the treasury of the parent company of a large sum of money which may embarrass, even though temporarily, its own affairs.

(2) Plans whereby the actual outlay of money from the treasury of the parent company is avoided, are more favored.

By these latter plans, the parent company issues its collateral trust bonds, its own direct obligation, and exchanges them for the stocks and bonds of the subsidiary company. After the exchange is made, it then deposits these stocks and bonds of the subsidiary company, in trust with the trustee under its collateral trust mortgage, as security for its own collateral trust bonds, which it has given the subsidiary company in exchange for the stocks and bonds of the latter. The parent company, in this instance, does not pay out in cash; it merely exchanges its collateral trust bonds for the stocks and bonds of the subsidiary company, and when the latter are received they are deposited as security for the collateral trust bonds of the parent company. The subsidiary company then sells these collateral trust bonds, the obligation of the parent company, and with the proceeds builds the extension or branch. By this method the parent company only pays interest on its issue of collateral trust bonds and awaits the time when the subsidiary company road will be built and earning

income to pay the interest on its bonds and dividends on its capital stock.

(3) The other plan by which the parent company avoids an actual outlay is that whereby it issues its collateral trust bonds, secured by a mortgage, and sells them on the market. By the terms of this mortgage, the trustee receives the proceeds from the sale of the collateral trust bonds and with it immediately purchases an equal amount in value, as regulated in the mortgage, of the bonds and the stock of the subsidiary company. He then holds these stocks and bonds so purchased as security under the collateral trust mortgage. In this case, the transaction is, in effect, similar to the last method, except that the collateral trust bonds are sold by the parent company instead of by the subsidiary company.

In neither of the last two cases does the parent company advance the money; it merely pays the interest on the collateral trust bonds, until the branch line is built and earns income and can pay interest on its bonds and dividends on its stock. This is its only outlay of money. When the subsidiary company pays such interest and dividends, they will at least be sufficient to pay the interest on the collateral trust bonds and thus relieve the parent company from further outlay.

As a security the collateral trust bond is said to commend itself, as it is the direct obligation of the parent company, usually of a large system, and is

quite generally secured by a first lien upon some specific piece of property or division of the system, instead of being secured, as is the ordinary railroad mortgage bond, upon an entire system subject to a number of prior liens and mortgages. The question of the value of the property covered by the deposited mortgage and represented by the deposited stock, of course, enters largely into consideration.

Bonds of consolidated railroads; bonds of the constituent roads.

The term "consolidated bonds" is used to designate those issued by a railroad company that has been formed by the consolidation of two or more railroad companies, theretofore existing as separate corporations. Each company that was consolidated or merged is called a "constituent" company.

The effect of consolidation or merger of two or more railroads is to extinguish the original or constituent companies and, by combining them, form a new company. Though for the purpose of continuing their obligations, each constituent company is presumed, in theory, to continue.

This new company, under the agreement for the consolidation, or under the statutes pursuant to which the consolidation was carried out, acquires all the property of the constituent companies, and must meet and pay all the debts and other obligations of such constituent companies.

The term "consolidated" bonds is also employed sometimes to designate an issue by a railroad company to raise money to build a branch or extension, and secured by a mortgage on this branch or extension and also on the main line. In such case, as to the branch or extension, this mortgage is a first mortgage, and as to the main line, it takes its place behind whatever mortgages may already exist against that property. An issue of this kind, when a first mortgage on the extension, and no matter what its standing as a lien on the property of the main line, is usually called "first consolidated mortgage" bonds.

The consolidated bond, issued by a consolidated company, is usually secured by a mortgage issued by such consolidated company, which creates a lien on its property. That is, the mortgage is on the property owned by the consolidated company at the time the mortgage was executed. It should always be borne in mind that any mortgages or other liens that the consolidated company may create against its property is always subject, inferior and junior to those mortgages or other liens that existed against that property at the time of the consolidation or merger. In other words, the consolidated company takes the property from its constituent companies in the condition it was in at the time of the consolidation or merger; and if the constituent company had, prior to that time, placed any mortgage or other lien against it, the property passes into the possession

of the consolidated company with these mortgages or other liens continuing in full force; and when this property is sold, it must first satisfy, in full, such mortgages or other liens that the constituent companies may have placed against it prior to the consolidation or merger, before the holders of the bonds issued after the consolidation or merger, by the consolidated company, receive anything.

The mortgages or other liens placed on the property by the constituent companies before consolidation are referred to as underlying liens. See *Underlying liens.* Page 271.

The mortgages that the consolidated company gives have priority over the unsecured creditors of the constituent companies, in payment out of the property covered by such mortgages.

The distinction between the consolidation and the reorganization of a railroad is so generally known, that to point out the salient differences here may seem a superfluous statement of elementary principles. In both cases a new corporation succeeds the old one. The reorganization of a railroad may be perfected among its stockholders, its bondholders or other creditors, without any court proceedings; though a road is usually reorganized after foreclosure of a defaulted mortgage. There is then usually some difficulty or embarrassment, financial or otherwise. The consolidation of railroads is not the result of any judicial or court proceedings, nor

the result of any financial or other embarrassment of the road, but is carried out by an agreement, authorized by the statutes of the States, between two or more railroad corporations, after the proper consents of their respective stockholders have been obtained. In this agreement, provision is made usually for the distribution of the intended stock of the new corporation, for its taking over the property of the constituent companies, and for its assuming the bonds and other debts and obligations of the constituent companies.

The holders of the bonds of the constituent companies have no voice in whether or not their company, upon whose property they have a mortgage, shall consolidate. They are not affected for that company can do nothing, in this respect, that will prejudice the lien of the mortgage against its property securing these outstanding bonds. Such mortgaged property is taken over by the consolidated company with the lien of all the mortgages against it continuing in full force. And, as was seen, any mortgage or other lien that the consolidated company may attempt to charge against this property must be inferior and junior to and is paid out of that property after the claims of bondholders under the mortgages of the constituent companies before consolidation have been paid in full.

The rights and remedies of holders of the bonds of the constituent companies cannot be taken from

them by this agreement between the railroad company and others to which they are not parties and have not consented.

Where no other arrangement is made the consolidated company is answerable for the debts and liabilities of each constituent company to the extent of the property acquired from it, though it usually assumes full liability for such debts and obligations without any limitation. However, any mortgage that the consolidated company may give on the property it acquires by the consolidation from the constituent company, though it is subject to all mortgages already existing against it, is entitled to priority over the unsecured debts of that constituent company.

The consolidated company having thus acquired the franchises of the constituent companies must assume and perform all the public duties which were imposed upon the latter by their respective charters and franchises.

The holders of the bonds of the constituent companies, however, cannot arbitrarily be compelled to accept the liability of the consolidated company in place of that of their original issuing company. The holder of the mortgage bonds of railroad companies is presumed, in law, to have in view at the time of his purchase that the company has the power to consolidate with another or other railroad companies. He takes his bond and mortgage sub-

ject to such public laws, as may exist at the time, authorizing railroad companies to consolidate, and he is bound by any provision they may make with respect to his right to convert his bond into the capital stock of the constituent company or the consolidated company.

He will not be deprived of his right to convert his bonds into capital stock by the consolidation or merger of the company issuing his bonds, though such rights may be regulated by the statutes permitting such consolidation. Holders of railroad bonds are bound by all laws regulating consolidations or mergers. Such regulations are usually to the effect that the bondholders with such privilege of conversion must demand their stock in the constituent company within a designated period. They must have a fair opportunity to do so.

Should they not demand their stock within the time the statute limits them to, they are presumed to have assented to the plan and agreement of consolidation and the provisions therein made for them. These provisions are usually that the holders of the bonds of the constituent companies, having the privilege of conversion, shall be entitled to receive stock in the consolidated company, instead of in the constituent company, should they choose it or should they not exercise their right to demand stock of the constituent company within the time or in the manner regulated by the statute.

Should the statutes or agreement, under which the consolidation was carried out, make no provision for conversion by the holders of the bonds of the constituent companies into their capital stock, and should the consolidated company have assumed the obligations of the constituent companies, then such bondholders are entitled to demand and receive stock of the consolidated company.

Divisional bonds.

As the name suggests, divisional bonds are those secured by a mortgage on a division only of a system.

They are sometimes issued by a subsidiary company and secured by a mortgage on its property, which is a branch or division of the parent company or main road. The parent company sometimes guarantees the bonds of its subsidiary companies.

The security in the case of the divisional bond is limited to that covered by the mortgage which covers only that branch or division. Such divisional bonds are not the direct obligation of the parent company. Should there be no guarantee, the parent company is in no way liable on these bonds; should there be a guarantee the liability of the parent company is limited to the terms of the guaranty. See *Guaranteed bonds*. Page 293.

Divisional bonds, sometimes, are the direct obli-

gations of the parent company but secured only by a mortgage on a division. As to the other parts or divisions of the system which the mortgage does not cover, the holders of these divisional bonds have no recourse until all the mortgages and other liens thereon have been satisfied in full.

The name "divisional bonds" is also sometimes given to the issue of a railroad that has subsequently consolidated. It is really the bond of one of the constituent companies that formerly operated a road that is now a branch or a division of the parent or main company, such issue having been secured by a mortgage on such branch or division executed by the constituent company before consolidation. Such divisional bonds are entitled to be paid in full out of the division covered by their mortgage before any of the issues, secured by mortgage on the same property subsequently put out by the consolidated company, receive anything from that division.

Guaranteed bonds.

Guaranteed bonds are issued by one railroad company and guaranteed by another.

The contract of guaranty is usually a printed or written form executed by the guaranteeing company whereby, for value received, it guarantees the payment of the principal or the interest of the bonds, or both, as the case may be, at the time and place where

they are payable. The guaranty may be endorsed upon each bond or by one separate contract include the entire issue.

When the issue of bonds is guaranteed before it is put out, the guaranty is endorsed upon each bond and the bonds are usually known as "guaranteed by endorsement." If the guaranty is given after the issue, or part of it, has been put out then, of course, the guaranty cannot be endorsed upon each bond already out, nor would it be practicable to recall the bonds to have them so endorsed. The guaranty is then made by a separate contract. The effect, however, is the same. As to those bonds that have not been put out at the time the guaranty is made, it may be endorsed on them or they may also be included in the separate contract of guaranty.

The guaranty may be to the bondholders direct or to the trustee in their behalf.

The contract of guaranty is a contract independent of the obligation of the issuing company. It may be so far an independent obligation of the guaranteeing company that it may be liable on its guaranty even though the bonds it guarantees are void.

The guaranty of the bonds, no matter in which form it may be, is an incident to such bonds and passes into the hands of whomsoever such bonds may come. Each successive holder of the guaranteed bonds is entitled to enforce the guaranty while he holds it.

Guaranties vary in their terms according to the objects to be attained and the circumstances attending the giving of the guaranty. Therefore, just what the guaranteeing company undertakes to do should be fully understood. It cannot be held beyond the strict terms of its guaranty. If its liability depends upon any conditions, these conditions should be fully understood. No doubt or ambiguity should exist as to just what the guaranty is. In a full guaranty, the guaranteeing company's liability should be commensurate with that of the issuing company. That is, the guaranteeing company should be liable to do and to pay all that the issuing company should; and the liability of the guaranteeing company should become fixed immediately upon the default of the issuing company, without any preliminaries of any kind.

The situations and reasons that bring about a guaranty of railroad bonds are many and varied. The one most common is that of a parent company, the main company of a system, guaranteeing the bonds issued by one of its constituent or subsidiary companies or issued by a road that it controls by lease or otherwise.

The guaranteeing of railroad bonds also results from the plan for the reorganization or readjustment of the affairs of a road. The bondholders of the old company find often that it is to their best interests to help along the reorganization or readjustment

by making concessions. At such a time they may accept bonds for a less amount, or for a lower rate of interest, in exchange for their own. They are often induced to do so by the guaranty of the interest or the principal, or both, of their bonds.

Guaranteed bonds result also from the use in common of stations, bridges, terminals or other property by two or more railroad companies. One or more of these companies will guarantee the bonds of the company that owns the property so used in common. The bonds so guaranteed are usually secured by a mortgage only on this property so used in common, though the mortgage may be on other property of the issuing company.

The after acquired property clause in railroad mortgages may sometimes result in a guaranty of an issue of bonds. The parent company which has already issued and has outstanding its mortgage containing an after acquired property clause, may want to acquire another branch or division or extension. This newly acquired property may fall within the mortgage, under the clause mentioned; therefore, to keep it from the inclusion of that after acquired property clause, the property is taken in the name of a corporation purposely organized to hold it. An issue of bonds is put out by that new corporation, secured by a mortgage on this newly acquired branch, division or extension, and guaranteed by the parent company.

Sometimes this device of holding the property in the name of a separate company is necessary where the mortgages of the parent company already existing, have reached the limitation of indebtedness fixed by the laws of the State in which it was incorporated; or where under the laws of the State in which the new division or other newly acquired property is situated, it is necessary that a resident corporation shall own it.

The railroad company formed by consolidation or merger may guarantee the bonds its constituent companies issued before such consolidation or merger.

The guaranty may be of the interest or of the principal, or both.

The guaranty of interest may or may not run for the entire term of the bonds.

When interest is guaranteed, in some instances, it is done for a limited period only. This is when a comparatively new company issues its bonds at a time when the public may not have confidence in its ability to earn the interest on its bonded indebtedness during the period that it is establishing itself. Under such circumstances, the interest is guaranteed for such time as will carry it over the period of development and growth. Then the inquiry intrudes: Are the possibilities of the road such as to develop sufficient strength to meet payments of interest beyond that period and of the principal when due?

Should principal only be guaranteed, and the bonds are for a long time, the intending bondholder should consider that in the meantime much may happen with regard to the relation between the subsidiary company and the guaranteeing company, and the standing of the latter.

Upon a reorganization of the guaranteeing company its relation to the subsidiary company, whose bonds it has guaranteed, and which it has operated under a lease, is usually changed. The lease will then probably be readjusted in some way. It may be dropped entirely or changed to meet new conditions.

The leased road sometimes requires security from the leasing company that the latter will perform all the obligations imposed upon it by the lease; and, accordingly, securities are deposited in trust, to be forfeited upon a breach of the lease. This, of course, adds to the guaranty and makes the lease something not to be lightly discarded.

The holders of guaranteed bonds are not creditors of the guaranteeing company until the latter has become actually liable. That is, there must have been a default in the guaranteed bonds and the guaranteeing company must have become actually liable under its guaranty. Should the guaranteed bonds not yet be due and the guaranteeing company become insolvent the holders of the guaranteed bonds are not entitled to have a dividend declared in their

favor as creditors of the guaranteeing company, nor are they entitled to have money retained in court to meet a possible future liability on the guaranty. Nor are the holders of the guaranteed bonds entitled to come in as creditors upon the reorganization of the guaranteeing company. But a provision may be properly contained in the agreement of guaranty entitling the holders of the guaranteed bonds to prove their claims as creditors of the guaranteeing company, in case of its insolvency, and to come in as creditors upon its reorganization, whether or not the bonds have been defaulted by the issuing company and whether or not the guaranty has become at that time enforceable. In the absence of such an agreement, the holders of the guaranteed bonds are not entitled to prove their claims against the guaranteeing company in case of its insolvency, nor to come in as creditors upon its reorganization, until the bonds have been defaulted by the issuing company and the guaranteeing company has become liable on its guaranty.

Should the guaranteeing company pay the bonds under its guaranty, it is entitled to be reimbursed from the company whose bonds it has thus paid. The guaranteeing company then becomes a creditor of the latter company to the extent of its payment on its guaranty. It is then entitled to all the rights that the holders of the guaranteed bonds that have been paid were entitled to, as such, against the issu-

ing company, and it may accordingly enforce the payment of the bonds it has thus paid. The guaranteeing company then takes the place of the holders of the bonds it has paid, thus becoming a creditor of the issuing company.

However, should the guaranteeing company pay coupons as they fall due and then hold them against the issuing company, they would be competing creditors with the holders of the guaranteed bonds and of the subsequently maturing guaranteed coupons. The guaranteeing company would thus take from such holders part of their security. To prevent this it is usually arranged that should the guaranteeing company pay the coupons, the trustee under the mortgage shall receive the coupons so paid and cancel them. But sometimes the guaranteeing company has arranged as a condition of its guaranty that should it pay any monies under its guaranty, it shall be entitled to receive an equal amount of interest coupons, and that on foreclosure it shall be entitled to payment of these coupons out of the mortgaged property, though not in opposition to or in diminution of the claims of the holders of the guaranteed bonds or coupons. In this way the guaranteed interest is paid but the coupons are not canceled; and while to the issuing company and its other creditors these coupons are considered unpaid, as to the holders of the guaranteed bonds and the other coupons, they are presumed to be canceled

and paid and not to be enforced so as to conflict or diminish their claims in any way.

It is not part of the ordinary business of a railroad company to lend its credit by guaranteeing the bonds of another company. Therefore, it is necessary that a railroad company shall have the power to guarantee the bonds of another railroad company expressly conferred upon it as it is not one of the inherent powers ordinarily possessed by railroad corporations; but the courts have recognized and established the rule that a railroad company may guarantee the bonds of another railroad company when the power to do so, though not expressly given, may be inferred from other powers and necessities.

The ownership of stock in a subsidiary company by a parent company empowers the latter to guarantee the bonds of the former.

If the railroad company have the power to consolidate with another, it has the power to guarantee the bonds of such corporation. The railroad company that controls another by lease, may guarantee the bonds of the latter. Sometimes the guaranteeing company pays the interest on the bonds under the contract of guaranty. Where the guaranteeing company pays the interest on the bonds of the road it has leased, the lease may provide that the payment of such interest shall be part of the rental.

The guaranty given by a railroad company with-

out any power to make the contract of guaranty is absolutely void and cannot be enforced. The law thereby protects the creditors and stockholders of the guaranteeing company, for any unauthorized attempt at guaranty risks the capital of the guaranteeing company, to the extent of the guaranty, in the business of the company whose bonds are guaranteed; and the capital of the guaranteeing company is to that extent placed under the control of the officers of the guaranteed company, and is diverted from the purposes of its own affairs to which its stockholders and creditors are entitled to have it applied.

But the doctrine is quite generally applied that though the railroad company may have no express power to guarantee the bonds of another company, yet if the power to do so may be implied from its other powers, or is reasonably necessary to carry out the objects for which it is in business, this power to guarantee will be conceded to it.

And when the power to guarantee is contained in the charter of the guaranteeing company, or may be implied from its other powers, or may be reasonably necessary to carry out the purposes of its incorporation, then its stockholders, bondholders, and other creditors are presumed to have accepted their stock and purchased their bonds or otherwise extended their credits, respectively, with the probability that

the capital of their company might be used to guarantee the bonds of other companies.

As was seen, a guaranty given by a railroad company that did not have the requisite power is void; however, if the guaranteeing company had the power, but did not exercise it properly, it may not avoid liability by reason of any defect in the execution of the guaranty and, under some circumstances, it may be enforced. Where the intending bondholder acted upon the faith of the guaranty, without knowledge or notice of any defect, he can claim the full benefits of it; for the owner of the guaranteed bonds is ordinarily entitled to rest in the belief that the guaranteeing company has properly exercised its powers and has actually done all it should have done and had the power to do. The guaranteeing company will not under such circumstances be permitted to take advantage of its own wrong or mistake.

However, when the guaranty is beyond its powers it is void, no matter how correct it may be in form. The power is lacking. In the first case the company had the power to guaranty, but exercised it imperfectly, and the court corrects that error; in the latter case the company did not have any power to guaranty and the court cannot give it, for that is a function of the legislature only.

The guaranteeing company can be held liable on

its contract of guaranty only when, like in any other contract or agreement, it has received something as a consideration for its promise of guaranty. If the guaranty be given before the execution or delivery of the bonds, and is endorsed on the bonds before they are delivered, the purchase price of the bonds is the consideration paid for them and also for the guaranty. If the guaranty be given after the execution or delivery of the bonds, the guaranteeing company is not bound by the terms of the guaranty unless it has received something for its guaranty, a "consideration" as the legal expression is.

Holders of guaranteed bonds should see that the guaranteeing company consents to all material changes that are intended to be made in the bonds or in the mortgage; for any change in these instruments without the consent of the guaranteeing company will discharge it from further liability. A material change makes it a different contract from the one that was guaranteed. Whether or not the guaranteeing company is injured or in any way affected by such change is not considered. It is a different contract that now exists and is not the one that was guaranteed. The contract that was guaranteed is no longer in existence; the new contract resulting from such change has not been guaranteed.

Should the time for the payment of the principal or interest be extended without the consent of the guaranteeing company, it is discharged from lia-

bility. But the extension must be pursuant to an agreement for a definite time and not a mere forbearance to enforce remedies for a reasonable time. Whether or not the extension of time caused any injury to the guaranteeing company is not considered; the time for the payment that was guaranteed has been changed and the contract as guaranteed no longer exists, and it is released from liability on its guaranty.

When new bonds have been substituted for the ones that have been guaranteed, the guaranteeing company is released, unless a new guaranty is given. The old guaranty is at an end.

Holders of guaranteed railroad bonds, however, do not release the guaranteeing company where they take additional security for their bonds, provided there is no extension for the time of payment of the guaranteed bonds nor any material changes made in the original contract.

But if in addition to the guaranty and at the time it was given, the holders of the guaranteed bonds have other security and surrender the same, thus throwing the entire burden on the guaranteeing company, it works a release of the latter to the extent of the amount that it has been injured by the surrender of such other security. However, in a contract of guaranty, like all others, the courts in construing them try to find from their language just what the parties intended, and if from the contract it appears

that the bondholders have in their possession or control securities from which their claims can be collected, and that it may be reasonably presumed that it was intended that these securities should be used up before the guaranteeing company should be asked to pay, the court will direct that such collateral security be first exhausted. But if the guaranty be an absolute one and no such intention as just mentioned can be spelled from its terms then the holders of the guaranteed bonds may proceed against the guaranteeing company without first trying to realize out of such collateral securities. The language of the guaranty is of prime importance. It should be carefully noted whether the guaranty is to the effect that the guaranteeing company *will pay* as soon as the issuing company has defaulted, or that if the monies due from the issuing company cannot be *collected* from it, then it will pay.

The language of the guaranty in this particular should be closely examined. If it is to the effect that the bonds and the coupons *shall be paid* when they severally fall due, it is an absolute guaranty and immediately upon the default of the issuing company, the guaranteeing company becomes liable. No act on the part of the bondholders or their trustee in their behalf is necessary to fix the liability of the guaranteeing company.

The guarantee, however, may be that the principal and interest, or either, as the case may be, will

be *collected* from the issuing company. This is a guaranty of collection and a different situation presents itself. The guaranteeing company under such a guaranty becomes liable only after a failure to collect from the issuing company. Under the guaranty of *payment*, the guaranteeing company becomes liable immediately upon the failure of the issuing company to pay according to the terms of the bonds, and the mortgage if there be one.

In the guaranty of collection, the rule, rather broadly stated, is that all reasonable effort must be made and legal remedies pursued to collect from the issuing company, and then upon a failure to thus realize, the guaranteeing company becomes liable for such sums as are still unpaid. In some States the insolvency of the issuing railroad company relieves the holders of the guaranteed bonds from the duty of demanding payment of the company directly liable and pursuing their remedies against it, in order to hold the guaranteeing company liable.

The usual form of guaranty is substantially to the effect that the guaranteeing company agrees with whomsoever may be the holders of the bonds or the coupons, as the case may be, at the time the guarantee is to be enforced, that the issuing company will *pay* the principal of the bonds at maturity, or their interest coupons attached, as they severally fall due, and, therefore, is an absolute guaranty of payment, and the liability of the guaranteeing company be-

comes fixed immediately upon the default of the issuing company, without any preliminary steps.

Guaranteed bonds are sometimes judged by the strength of the guaranteeing company. Undoubtedly, if the principal and interest are guaranteed, without any limitation of liability, it is a valuable asset when written by a strong company. But the guaranty is sometimes given a false value on account of the feeling of safety that the word may impart. The intrinsic value of the bond, the legal strength of the guaranty and the financial strength of the guaranteeing company should be the subjects of inquiry and examination. The bond should stand on its own merits.

Stamped bonds.

Where a parent company guarantees the outstanding bonds of its subsidiary company to enable it to build a branch line, it will do so sometimes by stamping its guaranty on the bonds. That is, old bonds of an outstanding issue are endorsed with the guaranty by stamping. See *Guaranteed bonds.* Page 293.

In some issues, certain privileges or rights theretofore possessed by the holders of the bonds according to the terms of the bond or the mortgage may be modified or other changes necessitated by conditions arising since the issue was put out. These changes are usually brought about by a reorganization of

the railroad. These changes in the bond or the mortgage are then stamped on the bonds.

A reference to a bond as a "stamped" bond is notice to all intending purchasers that there is something added to it on mutual consent by stamping that changes the original bond or mortgage in some particular. The contract originally made between the holder and the issuing company and the trustee is thus changed and the change stamped upon the bond.

Assumed bonds.

These are the bonds of a subsidiary company that have been assumed by the parent company when it takes over the ownership or control of such subsidiary company.

The parent company may take over the bonds of its subsidiary company and make them its own direct obligation; or it may guarantee such bonds upon the issuing company becoming a part of the system of the parent company or being controlled by it.

Where the parent company assumes the bonds, it makes them its own obligation, they then have the same force as if it had originally issued them, with the exception that its liability dates from the time it assumed the bonds and not from the date they were issued or put out. If its liability were to date back to the time of issue, it might thereby deprive those of its creditors who may in the meantime have

obtained rights against its property, of their rights.

Should the parent or other company that assumes the bonds give no mortgage or other security, then the holders of such assumed bonds are, so far as the assuming company is concerned, merely general or unsecured creditors. As such they can only satisfy their claims against such assuming company after all mortgages or other liens against its property have been satisfied in full. As to property of such assuming company against which there are no mortgages or other liens, they share proportionately with the other general or unsecured creditors. See *General rules of distribution; secured and unsecured creditors.* Page 227.

Terminal bonds.

Terminal bonds are secured by a mortgage on terminal property.

Railroad companies often do not own the terminal property they use. Such property may be owned by one or more railroad companies and used with several others in common. When all the railroad companies that use the terminal property also own it, the bonds usually are the direct obligation of such owners and are secured by a mortgage on that terminal property. For security the holder of such bonds is limited, of course, to such terminal property that has been mortgaged and if that be insufficient to satisfy his claim, as to the balance he is a general

or unsecured creditor of the issuing railroad companies. See *Secured and unsecured creditors.* Page 227.

When several railroad companies use terminal property in common, and only one or more but not all own that property, the road or roads owning the terminal property may issue the bonds, making them their direct obligations, and then execute a mortgage charging such terminal property with the payment of such bonds. The other roads that do not own the terminal property, but which use it in common, may guaranty such bonds as to principal or interest, or both. The strength of this guaranty depends upon the form that the guaranty takes together with the standing of the company or companies behind it. The holders of such terminal bonds then can look to such terminal property that has been mortgaged to secure them. For any unpaid balance they are general or unsecured creditors of the issuing company, and they may also charge the guaranteeing company upon its guaranty.

Terminal bonds are sometimes the obligation of a terminal company that owns only the terminal property. That is, a separate corporation is incorporated to hold only such terminal property. The capital stock of the terminal company is usually held entirely by the roads using the terminal property. They thus control and practically own the terminal company.

The terminal company then issues its bonds secured by a mortgage on its property. These bonds are sometimes guaranteed by the railroad companies using this terminal property. Recourse can then only be had against the mortgaged property, i.e., the terminal property and the terminal company. The liability of the roads using the property is limited to the guaranties that may have been given.

The terminal company may not be owned or controlled by the railroad companies using its properties. It may be an independent and separate company having no relation with the roads using its terminal property other than of lessor and lessee. Its bonds may then be only its own direct obligation without any guaranty from such roads. The source of income then from which it pays the interest on its bonds and meets its other obligations and expenses, is the rental it receives from the roads using its property. Though under the circumstances just set forth, the road or roads using this property may also guarantee the bonds issued by this separate terminal corporation. See *Guaranteed bonds*. Page 293.

Bonds relating to development; development bonds.

As the name suggests "development" bonds are issued to raise money for the development of the road.

The railroad company is obligated by the terms of its mortgage securing such an issue, to use the money

thus raised for such purpose, and can be compelled to do so and can be restrained from using it for another object. In the mortgage the particular improvement, betterment, or addition to be made, which enhances the value of the road beyond mere repairs, is specified. It is usually set forth in the mortgage that the money shall be turned over to the railroad company by the trustee, in instalments of fixed amounts, from time to time, as the work progresses.

The nature and value of the mortgage that secures this issue must be examined into. A mortgage of this kind depends upon the circumstances under which the issue is put out, the condition of the road, and the property pledged to its payment.

The mortgage that secures a development issue may create a lien on all or on only a small portion of the road; or its lien may attach only to the development or addition. Its lien may be first as to a part of the mortgaged property (the improvement or addition) and an inferior and junior lien as to the other parts; or it may be a lien on all the property covered by the mortgage but of inferior and junior rank to whatever liens that may already exist against such property. The legal rank of such a mortgage and the property it covers is always a matter for inquiry.

Money for development, repairs, or additions is quite generally raised by means of a general or

blanket mortgage. Such mortgages are made liens upon all the property of the road and are for sums large enough to meet the present needs of the company, including developments, its future requirements, and also to take up prior mortgages. See *General mortgage bonds; blanket mortgage bonds*. Page 269.

Extensicn bonds.

When a road builds an extension to its own line, the bonds with which the building, maintenance, and operation of this extension are to be financed are sometimes referred to as "extension bonds." The custom is to have the extension built and operated by a company incorporated for that very purpose, thus creating a distinct legal body which is separate from the main or parent road whose extension it shall be.

This separate corporation then gives its mortgage on the new extension which constitutes its entire property. This mortgage is usually a first lien on such property. The parent company usually guarantees these so called extension bonds. See *Guaranteed bonds*. Page 293. Also see *Collateral trust bonds*. Page 277.

Bonds to construction company.

Branch lines or extensions are sometimes constructed by persons individually, or by a partner-

ship, or a corporation sometimes formed for that purpose. The road or extension is thus constructed and then turned over complete to the parent company.

In payment for such construction, the contractors receive securities issued against such branch or extension.

These securities may be the stocks or bonds, or both, of the corporation in the name of which the branch or extension is held, and issued by it, the bonds being secured by a mortgage on such branch or extension; or the parent company may hold the branch or extension in its own name, in which case it will issue its own direct obligations; or the new company in the name of which the branch line or extension is held may issue its own bonds secured by a mortgage on such branch or extension and guaranteed by the parent company. See *Collateral trust bonds.* Page 277; see also *Guaranteed bonds.* Page 293.

The advantage to the parent company in such an arrangement is that it is relieved of the work of construction and also relieved of the financing of the securities of the branch or extension company. The advantage to the construction company is that it makes a profit.

The thought should be present that there is the temptation for the constructors in marketing the securities they have thus acquired, to make a

"watered" profit; and that should the officers of the railroad company be the same as those of the construction company, or should other friendly relations exist between them, there is that opportunity to make an inside profit against which frail man is not always immune.

Car trust certificates or bonds; equipment trust certificates or bonds.

Car trust certificates or bonds, equipment trust certificates or bonds, and equipment bonds are secured by mortgages against cars or equipment only.

There is no difference between the bond and the certificate in these instances; they are the same instruments substantially. The terms as here employed are practically synonymous.

Equipment bonds are issued by the railroad company and are its own direct obligations. Car *trust* bonds or certificates and equipment *trust* bonds or certificates are the result of a trust arrangement, as the name suggests, and are not issued by the railroad company. They are issued by and are the obligation of the trustee who holds the cars or the equipment, as the case may be, under the trust plan.

In all these cases, however, the mortgage is against the cars or equipment, the legal title and ownership is held by the trustee, while the railroad company has the possession and the use of such property.

Under the car trust arrangement, the railroad company pays a yearly rental for the use of the cars which is employed to annually pay off the bonds in serials: and in the case of the equipment bonds, the direct obligations of the railroad company, it pays off and retires a certain proportion of the issue each year. In both cases, having in mind the deterioration of the value of the cars and the equipment, the bonded indebtedness is thus reduced as fast, if not faster, than the property diminishes in value. See *Equipment bonds.* Page 323.

Car *trust* certificates or bonds result from a car trust arrangement which is sometimes called the Philadelphia Plan.

This trust arrangement or plan is employed when the railroad company needs cars which it does not wish to purchase outright as that would mean the immediate outlay of money that often must first be raised. Should the railroad company take title to the cars they may fall under and be included within an after acquired property clause in a mortgage already existing against the road and thus not furnish a security to raise money for their purchase; or they may in some other way become subject to the attack of the creditors of the company. The common purpose of the car trust plan is, no matter what the other considerations may be, that they shall furnish the security for and be the means of raising the money necessary in large part for their own purchase.

Accordingly, an association is formed by capitalists purposely to build, or to have built, or to buy from others, the cars in question. A mortgage is made against these cars to a trustee and the title to them is transferred to him. The trustee now holds the legal title to the cars subject to the terms of this mortgage. He enters into a lease with the railroad company by which the cars are leased to the latter for a specified period, usually ten years.

The railroad company, under the lease, has the possession of the cars and the right to use them, and pays an annual rental therefor. These rentals are considered as instalments of the purchase price, and when the last instalment is paid, the railroad company becomes the owner of the cars.

Until the last instalment of this rent is paid to the trustee he, in behalf of the holders of the certificates or bonds, continues to own the cars.

The association which supplied the trustee with the cars in question originally, receives its return for the manufacture or purchase, as the case may be, by the sale of these bonds or certificates and the cash payment that the railroad company makes.

The railroad company pays in cash a certain proportion, usually twenty per centum, of the value of the cars at the time they are turned over to it, and the trustee issues his car trust certificates or bonds for the balance, which is usually eighty per centum.

Having in kind the deterioration in the value of

the cars, the certificates are issued in serials. The issue is usually divided into as many serials as the lease has years to run and one serial falls due each year. The lease runs for ten years usually. It is aimed to have the bonds paid off quicker than the property will depreciate. The indebtedness must diminish at a faster rate than does the value of the property.

The rental is paid to the trustee. This rental is usually such an amount as will pay the expenses of the trusteeship, yearly taxes, etc., the interest on the outstanding certificates or bonds of the issue and to retire the serials as they severally fall due.

The railroad company agrees to keep this property in good repair and to replace destroyed or worn out parts. It also agrees to keep this property properly insured. The trustee has the right to inspect the cars during the period of the lease to see that they are not being neglected.

Upon default by the railroad company in the payment of the rental, or other breach of its agreement, the trustee may usually, under the terms of the lease, retake the property and dispose of it as is therein specified. And upon such default it is usually agreed in the lease that the railroad company shall forfeit all monies already paid and shall continue liable for all rent then due and not paid.

The cars while in the possession of the railroad company and used by it are not subject to the claims

of any of its creditors, for the trustee owns the property.

When there is a default by the railroad company, as was seen, the trustee is entitled to seize the cars from the railroad company. However, private rights must sometimes give way to public interests, and when a railroad company becomes insolvent and a receiver is appointed to operate the road, the court may order that he continue the use of these cars. The fact that the receiver continues to use the cars does not make the lease binding upon him. He may accept or reject the lease made by the road that he now operates, under order of the court, as the interests he serves demands.

Notwithstanding that the receiver rejects the lease and refuses to be bound by its terms, he may nevertheless use the cars. He then pays a reasonable value for their use during the time he actually used them. The reasonable value he pays may or may not be the same amount as is mentioned in the lease as the rental. When the receiver has finished with these cars he turns them over, under the order of the court, to the trustee under the lease.

Where the railroad company has already paid a substantial part of the entire amount of rentals under the lease, the court may order that the receiver continue and pay the balance and complete the transaction, whereupon the railroad company becomes the absolute owner of the cars.

Should only a small portion of the purchase price or rentals have been paid, it is doubtful if the court will order the receiver to pay the balance and complete the transaction. The rentals paid by the receiver are regarded as expenses of the receivership and like all such expenses are paid in full before the holders of the bonds under the foreclosed mortgage received anything.

When property is sold under a "conditional" sale, the possession of such property is given over to the buyer but the title and ownership of it continues in the seller until the buyer has paid the full purchase price, whereupon the buyer becomes the owner. See *Conditional sales*. Page 255.

The car trust arrangement is sometimes called the Philadelphia Plan as it originated there, because the laws of Pennsylvania declared that a conditional sale, as above described, is void as to the creditors of the buyer and that they (such creditors) are entitled to take such property from the buyer in whose possession they find it in satisfaction of their claims just as if he were the actual owner. This is the law quite generally in all the States, in the absence of notice or knowledge on the part of the creditors that the actual ownership is not in such buyer.

The reason for this rule is that the creditors of the buyer who has this property in his possession with all the signs of apparent ownership, may be misled into believing that such buyer actually owns this

property and thereby may have been induced to have given him credit. The usual method of avoiding such a situation when property is sold under such conditions is to give notice to the world that the title and ownership is still in the seller and that the buyer merely has the right to use the property. This is done by recording the instrument containing the arrangement of the conditional sale in the office of the public official designated by law for that purpose, usually the register or the clerk of the county in which the property is.

In most States there are laws providing that the lease or conditional sale of cars of a railroad shall be valid only if such lease or contract is in writing and thus publicly recorded, or when the name of the association, lessor or seller, appears on both sides of each car covered by such arrangement. This is notice of the true ownership and no one is misled. Failure to observe these requirements will in most cases make the sale or lease void as to the creditors of the railroad company and they will be entitled then to claim such property in satisfaction of their claims.

The car trust certificates or bonds are limited to those transactions where cars are involved.

When other equipment and cars or other equipment alone is the subject matter of the arrangement the issue is usually called "equipment trust" bonds or certificates. The details of the arrangement are the

same as in the case of the car trust certificates or bonds.

Car trust certificates or bonds or equipment trust certificates or bonds are in coupon form as a rule, with the privilege of registering the principal.

Equipment bonds.

Sometimes instead of the trust arrangement or Philadelphia Plan, the railroad company may purchase or own equipment outright and execute its mortgage against it to raise money; under such mortgage the title to such equipment is conveyed to the trustee, and he holds it for the benefit of the holders of the equipment bonds to be issued.

Should the railroad company buy the equipment itself, it pays in cash usually about twenty per centum of its value and raises the balance by selling equipment bonds, its own direct obligation, secured by mortgage against such equipment. This mortgage is invariably a first lien against such property.

Equipment bonds are issued by the railroad company for about eighty per centum of the value of the equipment. They are the direct obligations of the railroad company and run for ten years as a general rule. They fall due serially. The issue is divided into as many serials as the issue has years to run. One serial falls due each year. The purpose of this is to have the bonds paid off at a faster rate than the equipment will depreciate in value.

In the meantime the railroad company has the pos-

session and use of the equipment, though the title thereto and the ownership thereof is in the trustee for the purposes set forth in the mortgage. Should the railroad company default in any payment, it is provided in the mortgage and in the lease that the trustee may proceed against this equipment, seize the same and realize thereon for all claims under his mortgage.

Bonds growing out of the reorganization or readjustment of the railroad company generally.

In the reorganization or readjustment of the affairs of a railroad company that is financially embarrassed, and in order to help it retrieve its standing, bondholders and other creditors of the road sometimes give up certain of their rights or consent to have them modified (See *Assented bonds*. Page 325); or waive the lien or priority of their mortgage in favor of a later issue of mortgage bonds (See *Prior lien bonds*. Page 326); or consent to scale or reduce their claims, in the case of bondholders, consenting to accept bonds for a less amount or for a lower rate of interest (See *Scaling*. Page 328); or accept bonds of the newly reorganized corporation or shares of its capital stock; or agree to extend the time for the payment of their bonds or notes (See *Extended bonds or notes*. Page 327); or the secured bondholders may give up their secur-

ity and in return have pledged to them the income of the road to pay the interest on their bonds (See *Income bonds.* Page 329), the principal of which may or may not be secured. The interest of the income bonds is payable out of the income of the road only when it is earned; if income be not earned the bonds receive no interest.

Assented bonds.

Where it is attempted to reorganize the road or to readjust its affairs, the plan for such reorganization or readjustment is usually submitted to the stockholders and the holders of the bonds of the different issues. This plan may, and it usually does, call for an assessment from the stockholders or some concession from the bondholders or holders of notes. Should the holders of such bonds or notes assent to such plan, they submit their bonds or notes, as the case may be, to the designated depositary and have stamped thereon the fact that the owner of such bond or note has assented to such plan. These bonds or notes are then called "assented" bonds or notes and all later holders take them subject to all the changes in the original terms of the bonds or notes, and in their mortgage where they are secured.

The assent becomes an incident of the bond or note and passes with it in each transfer thereafter, and affects the rights of every subsequent holder.

Prior lien bonds; preferential bonds.

The holders of the bonds of an insolvent road may consent that a new issue of bonds be put out to raise money to place the company on a hopeful basis, and that such issue shall have priority over their own bonds in payment out of the property mortgaged to secure them. That is, this new issue shall be secured on the same property as their bonds and, though later, shall be paid first. When bonds are thus given a prior lien by being thus preferred they are called "prior lien" bonds or "preferential" bonds.

It should be noted that the fact that they are given a preference and made a prior lien does not necessarily make them a first lien and prior to all other bonds. It means that the preference or priority thus given has reference only to the holders of those bonds who have consented to defer their own bonds. This consent is usually given because it is generally believed that with the aid of the funds thus raised, the consenting bondholders, notwithstanding the waiving of their lien in favor of the new bonds, will in the end be benefited by the results produced by the money thus raised. However, as to those who do not consent, the new bonds do not get this preference or priority, and the non-assenting bondholders retain their original priority of lien, and are unaffected by such later issue or the fact that the others have consented.

Where such consent is withheld, the conditions may be such that the mortgage may be foreclosed and the court appoint a receiver who will issue his certificates and thus raise the money that would have been forthcoming if the issue of prior lien or preferential bonds had not been blocked. These certificates may be given a prior lien over the mortgage. See *Receiver's certificates.* Page 210.

Extended bonds or notes.

In the reorganization or readjustment of a railroad company, the holders of its outstanding bonds or notes may consent to extend the time for the payment of their securities. This is usually done by surrendering their bonds or notes, as the case may be, and receiving in their place bonds or notes of a new issue with the extended date of maturity.

However, instead of issuing new bonds or notes the plan may be that the old ones may be retained and coupons for the interest of the additional period issued. When this is done and there is any other change made in the terms of the original bonds or notes, and of the mortgage if they are secured, such change is stamped on such old bonds or notes. See *Stamped bonds.* Page 308.

The same property that was pledged as security for the original bonds or notes usually remains as security for the new issue; though a different arrangement may at that time be made on consent.

The extended bonds or notes are sometimes issued for a higher rate of interest to induce the extension of time; or security or additional security may be given. Sometimes the holders of such bonds or notes may consider it wise to accept the same or a lower rate of interest and thus help out the road at this critical period, when with additional time requested it may adjust its affairs. An extension of the time of payment may release the guarantors. See *Guaranteed bonds*. Page 293.

Scaling.

By scaling is meant a reduction of the indebtedness of the road by the consent of its creditors. In the case of the holders of bonds or notes, each gives up a proportionate share of his holdings.

The amount of the outstanding indebtedness is reduced by the holders of the bonds and notes surrendering their holdings and receiving in exchange new bonds or notes, as the case may be, for the smaller amount and releasing the railroad company as to the balance. At the same time the new bonds or notes may be for a different rate of interest, or such other concessions made by such holders as the arrangement for the scaling may contemplate. The new bonds or notes, when secured, are entitled to the same rights under the mortgage that secured the surrendered bonds or notes as the latter had in the absence of anything to the contrary agreed upon by

the parties. But the arrangement under which the scaling is made may contain some other arrangement which will disturb the lien of the mortgage or the security that the holders had. It is all a matter of agreement between the parties; it is what they consent to. The holder of the bond or note that is sought to be scaled is not affected by any arrangement to that effect unless he has consented to it; the consent of the other holders of the same issue cannot affect his rights unless he has given them the power to bind them as in the case where he has consented to be bound by the vote of a majority of the holdings of that issue.

Income bonds; debenture income bonds; mortgage income bonds; non-cumulative income bonds; cumulative income bonds; assented income bonds.

Income bonds have their interest secured by a mortgage on the income of the railroad company. The right to receive any interest depends upon the fact whether or not sufficient income has been earned during that interest period to pay the interest.

If the railroad company does not earn the interest, the holders of the income bonds are not entitled to it. Its non-payment is not a default: as its payment is made dependent upon whether or not it is earned.

The interest only is usually secured; and the

security is not any tangible property of the road but is limited to the income only. The principal of income bonds may or may not be secured by mortgage on tangible property of the railroad company.

If the principal be not secured, then the holder of the income bonds, so far as its principal is concerned, is a general or unsecured creditor. They are then sometimes called "debenture" income bonds. See *Secured and unsecured creditors.* Page 227. See also *Debenture bonds.* Page 11.

If the principal of the income bonds is secured by a mortgage on the property of the railroad company, then the right of the holders of such bonds are the same under it as those of other bonds secured by railroad mortgages; that is, their priority and rank among the other incumbrances against the property depend upon the terms and conditions of the bonds and mortgage and the time when its lien attached to the property in question.

The income that is pledged to the payment of the interest of the income bonds is usually the net income arising from the operation of the road and its appurtenances; though the income may be limited to that from a certain source.

The rate of interest is fixed. The interest is payable semi-annually, as a rule.

The income that is pledged to the payment of each instalment of interest, as a rule, is that which has been earned during that interest period only.

Should there not be sufficient to pay all the interest of the income bonds for that period in full, then those entitled to such interest are paid proportionately out of the income of that period only. The entire interest, or any portion thereof, as the case may be, of a certain interest period may be lost if not earned during that same period. Such is the non-cumulative income bond.

The cumulative income bond provides otherwise. Those entitled to the interest of the cumulative income bond are entitled to have any deficit or loss of interest in any past period carried forward and paid out of future interest periods until all arrearages of interest have been paid in full.

These arrearages thus carried forward and charged on succeeding interest periods have no better rights than the interest charges of such later periods and are paid only out of the net income of such future periods after all prior charges.

Whether the income bond is cumulative or non-cumulative is stated on its face or in the mortgage securing it; should nothing be said on this point then the bond is non-cumulative and any loss of interest during one interest period is not carried forward and is not made a charge on succeeding interest periods, but is lost to the one entitled thereto.

Income, when the term is used with relation to income bonds, means net income or net earnings.

Ordinarily, the net income of a railroad is the dif-

ference between the gross earnings and the expenditures incurred in producing them. It is what is left after paying the expenses of producing the income, including the fixed charges.

What shall constitute income is often agreed upon in the bonds and the mortgage, and the mode of ascertaining it is regulated there also.

The bond or the mortgage may limit the income to be paid for interest on the income bonds to the income produced from certain specified sources, such as, from specified branch lines or divisions of the system, or it may embrace the income produced from all sources including that earned in the operation of all the lines and other property then owned by the railroad company making the issue and, in addition, from all that may be acquired at any time during the life of the mortgage.

The board of directors of a railroad company have a wide discretion in determining what shall be treated as income, in the absence of anything in the bond or the mortgage limiting their powers in that respect. The personnel of the board of directors is therefore an important factor to be considered, and it is worthy of attention that they shall not use monies that should go to the payment of interest on income bonds, to make betterments that enhance the value of the property beyond mere repairs, improvements, or extensions when they are not necessary.

The railroad company owes the duty to the hold-

ers of the income bonds to keep books of account of their earnings and expenses of the mortgaged road and the other property from which the income pledged to them is to be derived, so that they can readily see what the net income is. And the trustee under the mortgage securing the income bonds, when there is a mortgage securing them, owes the active duty to his bondholders to supervise the accounts and see that their rights are properly regarded.

The accounts should show the net income for each interest period. Where several lines or divisions of the road are separately mortgaged, the duty is then imposed on the railroad company to keep separate accounts as to each. And the holders of the income bonds issued against the income of one line or division have the right to insist that expenditures chargeable to another shall not be charged against the income mortgaged to them.

The gross earnings of a period shall bear only the expenses incurred in producing it and the fixed charges of the railroad company for that period. And the holders of non-cumulative income bonds are entitled to insist that a special or unusually large amount which fell due and was paid and was charged in any one interest period to their loss of interest, shall be apportioned among other interest periods and adjusted with a view to what is fair to the interests of all concerned.

When the affairs of a railroad company are affected by leasing or consolidation or merger, there is the likelihood that the standing of the income bonds may be changed. They are then sometimes guaranteed as to principal or interest, or both, by the new corporation, or the new system or some of its members, resulting from such consolidation or merger, or by the main or parent company which is a party to the lease. Or an arrangement may be substituted whereby a regular stipulated interest shall be paid and regarded as a fixed charge, to be paid on designated interest days. The interest thereafter is not dependent upon the earnings of income as was originally agreed upon but is a fixed charge.

When such changes are made in the income bonds, they are noted on the bonds themselves, and they are then known as "assented" income bonds; or the old issue may be surrendered and other bonds containing the changes are received in exchange. See *Assented bonds*. Page 325.

CHAPTER VIII

RIGHTS AND REMEDIES WITH RELATION TO THE REORGANIZATION OF THE RAILROAD COMPANY

Different forms of reorganization; new charter; sale or lease of property; consolidation or merger; by assessment of stockholders; bondholders waiving lien and accepting new securities; scaling; new management.

A reorganization of a railroad company, using the term broadly, is a readjustment of its affairs.

To proceed under a new charter after the time limited in the original one has expired, or where the original charter has been lost by forfeiture or dissolution of the railroad company, has been regarded, in this broad sense, as a reorganization.

The lease or sale of all or nearly all of the property of a railroad to another is in effect, quite generally, a reorganization of its affairs.

A reorganization results from the consolidation of one railroad with or its merger into one or more other railroad corporations or a system.

Other methods by which the affairs of an embarrassed railroad company are rearranged are called reorganizations that may be termed, more properly,

readjustments. For instance, the insolvency of the road and imminent foreclosure may be brought about because its earning capacity is limited, principally on account of lack of funds with which to provide adequate equipment and improvements necessary to develop its possibilities and enable its business to be handled with economy and profit. The funds necessary for this purpose are sometimes raised by assessing the stockholders. With the money so provided, interest due on the bonded indebtedness is paid, the road is equipped and put in a profit earning condition, restored to solvency, and a foreclosure avoided. However, should the stockholders refuse to pay the necessary assessment, then the bondholders foreclose their mortgage and ask the court to appoint a receiver, which is usually done. Under order of the court, receiver's certificates are issued and sold to raise the money with which to meet necessary requirements, and the road is thus continued in operation, and in time put in a profit earning condition. The proposition is then submitted to the stockholders that they supply the necessary money, to be raised by *pro rata* assessment among themselves, with which to pay off these certificates and the expenses of the receivership, and take back the road in its profit earning and readjusted condition. Should the stockholders not do so then the foreclosure proceeds to a sale of the mortgaged road.

Sometimes the secured bondholders come to the

aid of the insolvent road—which may be only temporarily embarrassed—and extend the time for the payment of their bonds or arrange about the interest. See *Extended bonds*. Page 327. Or they may waive the lien of their mortgage in favor of those lending money to the company at this critical time. See *Prior lien bonds; preferential bonds*. Page 326. This is done by such bondholders consenting that a new issue of bonds for a specified amount be issued and that it shall be secured by a mortgage on the property of the road which shall be entitled to priority in payment out of the mortgaged property over their mortgage; or they may consent that the holders of the new issue of bonds shall share with them equally in the security their mortgage gives them. These latter arrangements are accomplished by such bondholders surrendering their bonds and taking in exchange others under the new mortgage, which is issued for an amount that will cover the bonds to be surrendered and the bonds for the money to be raised. With the surplus so raised the road is relieved from the embarrassments that pressed it and resumes profitable operation. Or the bondholders may exchange their interest bearing bonds for income bonds, thus reducing the fixed charges and making the payment of interest dependent upon the fact that it has been earned. See *Income bonds*. Page 329.

Again, should the creditors and the stockholders

be willing, the affairs of the company may be placed upon a better footing by all consenting to give up part of their bonds, notes, claims, or stock, and thus reducing fixed charges relieve the company of the burdens, or some of them, that interfered with its profitable operation. This is called scaling. Each scales down his demands or rights proportionately. To carry out a readjustment of this kind the consent of those participating must be obtained. Those who do not consent occupy their original positions: the arrangement cannot be forced upon them. Should the holders of a large amount of the securities or claims sought to be scaled object, it renders the plan inoperative and a foreclosure and a receivership are likely to follow. The objection of the holders of a small amount may be overcome by purchasing their securities. See *Scaling*. Page 328.

Where the management of the road has been incompetent, inefficient, or influenced by conflicting interests or improper motives, a radical and complete change in this respect is also a kind of readjustment or reorganization.

Outline of procedure in reorganization.

When the trustee forecloses the mortgage or during the period when the affairs of the company have reached the crisis that makes reorganization expedient, the holders of the obligations of a railroad company and others financially interested in its

affairs usually come together, form an agreement among themselves and formulate and work out a plan by which the road is purchased, is put in as good physical and financial condition as the circumstances reasonably warrant, and is continued in operation.

The initiative is taken usually by the holders of the larger blocks of the securities or by a leading banking house.

The course pursued is for a number of men well known in the financial world, to form themselves into a committee which prepares and submits an agreement for reorganization, in which it is arranged that the bondholders and others participating shall deposit their securities with the depositary that is named (usually a trust company) and that thereupon they shall become parties to the agreement. These agreements are interchangeably called "reorganization agreements," "bondholders' agreements," or "agreements of deposit." By whatever name called, they are agreements under which the parties financially interested in the affairs of the embarrassed railroad attempt to reorganize it. The agreement contains the duties and rights of the committee and of those who become parties to it. Pursuant to this agreement a plan is adopted by which it is usually arranged that the road shall be purchased at the foreclosure sale or otherwise, by the committee, as the representative of the parties to the agreement. When the road is thus purchased

it is turned over to a new corporation. This new corporation takes the property thus conveyed to it, generally speaking, free from the debts of the old company, and proceeds to operate it under new management and relieved from many of the burdens that hampered the old company. The property is purchased with the bonds or other securities that have been deposited under the agreement, together with such assessments that may have been levied or monies raised by other means under the reorganization agreement or the plan. The securities of the new corporation are issued to those participating in the reorganization, to represent their interests in the property purchased. The new corporation is financed by selling its capital stock, by issuing its bonds or notes, and by obtaining credit.

Attitude of courts toward reorganizations; proposed reorganization must be fair.

The courts recognize that large sums of money are necessary to purchase railroad property at foreclosure sales, and therefore favor those means by which holders of the bonds and other obligations of the road may unite their securities and make a bid large enough to protect the property from sacrifice. By thus combining their securities, these holders are able to make a purchase which separately they could not.

The law condemns a reorganization that is merely

a guise for stifling competition in bidding; and the courts will stop such an attempt by injunction, and set the transfer aside if it is carried out.

That the holders of the outstanding obligations of the company, or a portion of them, have united for the purpose of purchasing the property of the road does not preclude others from bidding at the sale.

Courts favor reorganizations when proper as they save a probable sacrifice of the security, for the far greater value of railroad property lies not in its intrinsic value as property, but in its cohesive use and operation as a railroad. And, too, the reorganization of the road continues it in operation, thus enabling it to serve the public and to discharge its obligations in that regard.

The agreement and the plan for the reorganization must be fair. Should it be, in any way, fraudulent or oppressive to a minority, no matter how small, of the parties participating, the court will protect those against whom it unfairly operates and may prevent a reorganization from being carried out, or otherwise provide for them. Courts will not allow a majority, no matter how large, of the holders of the securities of the road, nor any set of them, to gain any advantage over their associates through the means of a reorganization.

The legislatures of nearly all the states have enacted laws aiding the purchasers of the franchise

and the property of a railroad corporation at a foreclosure sale to form a new corporation to continue the road in operation.

Rights of bondholders, generally, to participate in the reorganization; to receive notice and opportunity to examine proposed agreement for reorganization.

Each bondholder has an equal right to participate in any reorganization or proper combination by the other bondholders under the same mortgage to purchase the property of the road. The law will not permit any discrimination to be made against any bondholder of the same issue. All have a common interest in the security. Each has rights equal to the rights of those attempting the reorganization. All must have an equal opportunity to come in and share in the benefits of any reorganization and protect their security.

Each bondholder entitled to join in the reorganization must be given a fair opportunity to do so and to become acquainted with the terms of the proposed agreement for reorganization. He is entitled to a reasonable notice (usually by publication in the newspapers) of the terms of the agreement, or of the fact of its preparation and filing and where he may examine it. After this he must have a fair opportunity to decide whether or not he wishes to become a party to the agreement and participate in

the reorganization it contemplates. Printed copies of the agreement are usually furnished by the depositary on application.

Rights of bondholders who do not join in the reorganization; rights upon withdrawal from agreement or abandonment of reorganization; reorganization by majority against objections of minority; provisions in mortgage empowering majority; interest of minority protected by the courts.

A bondholder may refuse to join in the agreement or the plan for reorganization. He cannot be compelled to join as the enterprise of the new corporation that is contemplated cannot be forced upon him unless, by the terms of the mortgage securing his bond, he has agreed to be a party to the reorganization proceedings commenced under it by the holders of a majority (or other designated proportion) in amount of the outstanding bonds of that issue.

A bondholder is entitled to stand upon his original rights and to receive his proportionate share of the proceeds of the sale of the property that was mortgaged or pledged to secure the issue of bonds of which he holds. His rights in this respect cannot be affected, in any way, by a reorganization to which he is not a party.

One who was a party to a reorganization agreement, but has withdrawn from it, stands upon

the same footing as he did before he became a party to such agreement, and is entitled to his proportionate share of the proceeds of the sale of the property that was mortgaged or pledged to secure the issue of which he holds. And when a reorganization is abandoned, in the absence of anything agreed upon to the contrary, the rights of the parties are the same as if no reorganization had been attempted: that is, each is entitled to his proportionate share of the proceeds of the sale of the property that was mortgaged or pledged to secure the issue of which he holds. When an attempted reorganization is dissolved or abandoned it is invariably only under some arrangement whereby its parties shall pay proportionately certain specific expenses or advances and bear obligations already incurred.

In some railroad mortgages a provision is contained that the holders of a majority, in amount of the obligations it secures, shall have the power to reorganize the road upon its default and insolvency. A majority of a specified proportion may be mentioned. The majority, or the requisite majority, under such a provision, formulate their reorganization agreement and plan, and it is binding on the minority. The minority under these circumstances will not be heard to object because it has consented to be bound by the act of such majority, in this regard, when it accepted its bonds under the mortgage containing this provision. But the majority must

exercise this power in good faith. Should it abuse it and act fraudulently or oppressively, the minority will not be bound by its acts.

And even though there be no such provision in the mortgage giving the majority the power to reorganize and bind the minority by its acts, or of any statute to the same effect, the courts will not permit a small minority, representing a comparatively insignificant amount of the outstanding bonds, to defeat the wishes of an overwhelming majority in amount, when there is no pretense of fraud or unfairness in what the latter propose doing. The action of the courts in this regard is based upon the conclusion that the public obligation that the railroad company owes to continue the road in operation, is superior to the private property rights of such minority; and, therefore, under the circumstances mentioned, will assist in carrying out a railroad reorganization against the objections of a small minority, in amount, of bondholders.

When the reorganization is thus carried through against the objections of a minority, the court will see that such minority is fairly treated and its interests fully protected. The provisions for the objecting minority depend entirely upon the facts and circumstances of each particular case before the court. The precedents show that the courts have ordered that the bonds of the minority be taken care of by deposit of the money due with the court,

or by an indemnity bond, to secure their payment.

Bondholders may reorganize alone; or with other creditors, or with the stockholders, or with both; interests of unsecured creditors protected; rights of stockholders of insolvent company; terms upon which they may acquire rights in new company.

It has been found expedient, at times, that the bondholders, secured by the foreclosed mortgage, should ask other creditors of the insolvent company or its stockholders, or both, to join them in a proposed reorganization, and share in the new corporation according to their respective rights, as well as the same can be adjusted. This is to avoid the embarrassment and delay that such other creditors and stockholders may cause to a reorganization conducted exclusively by the bondholders under the foreclosed mortgage; and, as the stockholders usually pay in cash for such stock of the new corporation that they get, the money thus raised is a timely aid to the new corporation and helps along the reorganization.

The bondholders under the foreclosed mortgage and the stockholders may unite for the purpose of reorganizing; but such a combination must not be for any fraudulent purpose. And where unsecured creditors show that the purchase and reorganization by the bondholders in combination with the stock-

holders (or a reorganization by the stockholders alone) is for the purpose of destroying their interests, they are entitled to have all proceedings stayed until the matter has been fully examined into and their interests accorded a proper protection; if the property has been already purchased and taken over, they may follow it into the possession of the new corporation and the courts will enforce their rights against it.

Stockholders of the old corporation have no right to any of its property until every creditor has been paid in full; and if by any plan of reorganization, or otherwise, they attempt to take to themselves property of the road before every creditor has been paid in full, it is a fraud on such unpaid creditors who may enforce their claims, according to their respective ranks, against such property that the stockholders have thus wrongfully taken to themselves.

A stockholder is entitled to his proportionate share of the assets of the corporation after every debt has been paid in full and every obligation has been fully discharged. The ownership of stock in an *insolvent* corporation carries with it no rights in its assets. If the company be insolvent, it has not sufficient assets to pay all its creditors, and, therefore, it owns nothing itself, and its stock cannot represent anything. And stockholders in an *insolvent* railroad company can acquire no rights in the new corporation by reason of their ownership of stock in the old

company; they must pay for any rights in the new company with money or property.

However, that one is a stockholder in the insolvent railroad company is no objection to his participating in the reorganization independently of his ownership of stock; for he may be also a bondholder or other creditor of the road, or he may pay for whatever interest in the new company that he may acquire.

As the foreclosure sale of the property of the insolvent company cuts off all rights of its stockholders in the property sold, they can have no rights in the property taken over by the new corporation, and can have only such rights in the new corporation or its property as the reorganization agreement or the plan gives them. And it is quite proper for the agreement or the plan to make provision for the stockholders. These provisions are usually to the effect that the stockholders may obtain stock in the new corporation by surrendering their old stock and paying a specified sum for the new stock. The agreement or the plan may leave it to the committee to fix this amount. The committee must render an accounting of expenses and indebtednesses showing the financial condition that exists, and revealing the computation upon which it bases the amount of this assessment, so that they (the stockholders) may have an opportunity to examine into the matter, and call upon the court to protect them should the as-

sessment be unfair or improper. However, in the absence of fraud or unreasonable conduct in fixing this amount, the court will not interfere with the action of the committee.

Synopsis of reorganization agreement.

The agreements by which the reorganization of a railroad company is attempted to be worked out are variously known as "reorganization agreements," "depositors' agreements," or "bondholders' agreements."

This agreement is made between the committee, the bondholders under the foreclosed mortgage and such others as shall join in with them. The depositary is also sometimes made a party.

A reorganization agreement is a contract between the parties to it. It appoints the committee which shall represent the bondholders and the other parties to it, in the reorganization proceedings. It usually provides that the parties shall deposit their bonds or other securities, and gives in detail the rights and obligations of those who become parties to it. The powers and duties of the committee with relation to such deposited securities and such other property as it may acquire in the course of the reorganization are specified. It provides for the preparation and adoption of the plan (which is usually a separate document) by which the property of the road shall be purchased, the new corporation formed, and

property conveyed to it. It sets forth the rights of all the participating parties in such new corporation. The agreement or the plan may also provide for further powers in the committee, such as making changes in the agreement or the plan, extending the time within which the securities shall be deposited, and extending the time within which the plan shall be consented to or objected to. Provisions may be contained also, either in the agreement or in the plan, as to the expenses and compensation of the committee, and how such committee shall be constituted when its membership is depleted by resignation, death, or otherwise. The agreement or the plan may provide for assessments to be charged against the bondholders and others participating in the reorganization.

In most of the States there are statutes relating to reorganization of railroad corporations; and when this is the case, the provisions of such statutes are part of the reorganization agreement and the plan, and the parties are bound by them with the same force and effect as if they were set out in the agreement or the plan at length and in detail.

Becoming a party to the agreement; by signing; by deposit of securities; limitation of period; extension of period; penalty.

The agreement states the manner in which the bondholder shall become a party to it. Some pro-

vide, though rarely, that one may become a party to it by signing his name thereto. Most agreements, however, declare that one shall become a party to them by depositing the specified securities held by him against the insolvent corporation with the depositary. The act of depositing and the acceptance of the certificate of deposit, issued by the depositary, signify a consent to the agreement and its terms, and the depositor then becomes a party to it with the same effect as if he had subscribed his name to such agreement. When the bondholder deposits his bonds he receives a certificate of deposit from the depositary, which represents the securities deposited by him. See *Certificate of deposit.* Page 353.

Usually the time within which one may become a party, in any of the ways mentioned, is limited. The time may be extended by the committee or by the court. To have the time thus extended is not an absolute right that the bondholder may insist upon; it rests with the committee whether or not the time shall be extended. However, the courts seem disposed, judging from the trend of decisions, to permit bondholders an opportunity to come in and share in the reorganization upon such terms as shall be fair to all the parties, up to the time of the foreclosure sale and in some instances thereafter.

As a condition for the privilege of coming in after the time has expired, the court or the committee, whichever grants the privilege, may impose a pen-

alty. The amount of the penalty imposed on each bond usually does not exceed one per centum of its face amount.

And extension of the time within which the bonds may be deposited after the time limit has expired may be conferred on all bondholders generally or in specific cases only.

After one has become a party to the agreement, in order to continue as such party and enjoy its benefits, one must comply with all its requirements as to assenting to or dissenting from the plans submitted, paying assessments, and meeting all other conditions it may contain.

Use of deposited bonds; how bonds deposited.

The requirement that bondholders in order to become parties to the agreement for reorganization shall deposit their bonds with the depositary serves a double purpose, for in addition to signifying the intention to join the agreement, it places the bonds in the control of the committee to use them to purchase the property of the road and also for the other purposes of the reorganization.

The committee holds the deposited bonds in trust for the purposes of the reorganization. It may use them only in strict accordance with the terms of the agreement under which they were deposited. The agreement usually authorizes the committee to use and dispose of the deposited bonds to purchase the

property of the insolvent road, and for any other purpose which in its judgment it believes necessary to carry out the reorganization.

Coupon bonds are deposited with all unpaid coupons attached, that is, coupons that have matured and have not been paid and those not yet matured.

Registered bonds are deposited with such transfers, assignments, powers of attorney, or proxies, invariably in blank, as will pass a full title to such bonds to the committee and enable it to use them for the reorganization.

Upon receiving the bonds the depositary issues a certificate of deposit to the depositor. Temporary receipts are usually issued, which are later exchanged for the engraved certificates of deposit.

Certificate of deposit; its transfer; negotiability; rights of transferor and transferee; interest on bonds represented by certificates of deposit.

The certificate of deposit is a writing issued by the depositary upon receiving the bonds or other securities deposited under the agreement. It is in such form as the committee shall approve. It invariably certifies that the depositary has received from the depositing party certain bonds, describing them, with coupons attached, if that be the case; that the bonds have been deposited subject to the terms and conditions of the agreement for reorganization and that the holder of such certificate, by

accepting it, consents to and is bound by the provisions of the agreement and is entitled to share in all benefits and advantages of the reorganization; or (it continues), the bonds so deposited, together with the coupons attached, may be returned to or withdrawn by the holder of the certificate, upon compliance with the terms of the agreement, by presenting and surrendering the certificate, duly endorsed. The certificate further states that it is transferable only on the books kept for that purpose at the office of the depositary, upon surrender of such certificate, duly endorsed, and thereupon a new certificate will be issued to the transferee in exchange.

The committee usually has the power to declare the transfer or registration books of the depositary closed, from time to time, for such periods as it may deem expedient.

The certificate of deposit may be made payable to bearer. It is then transferable by delivery from hand to hand. As a rule, however, these certificates are not made payable to bearer, but are made in the name of the depositor, and each transfer must be registered on the books of the depositary, if its new owner wishes to claim rights as a party to the reorganization. When in this usual form, to transfer it, it is presented and surrendered to the depositary and a new certificate is issued in its place, which is in turn registered in the name of the new owner.

The certificate of deposit is impressed with the

terms of the agreement into the hands of whomsoever it may be.

Should the holder of a certificate transfer it, the new holder becomes substituted in his place as a party to the agreement and is entitled to all its benefits and charged with all its duties.

It is invariably provided in the agreements, that the holders or bearers for the time being of negotiable certificates of deposit, and the registered holders for the time being of registered certificates of deposit, may be regarded as the absolute owners thereof and possessed of all the rights and charged with all the duties of the original owners.

Certificates of deposit are sometimes listed on the stock exchanges.

They do not draw interest. Of course, the interest on the bond continues to run during the foreclosure action, but it is not paid as a rule, unless there is money on hand for that purpose and the court orders the receiver to do so. Should conditions warrant it the court may order the receiver to pay the instalment of interest due. As the committee is to all intents and purposes the owner of the deposited bonds so far as the right to receive the interest or principal thereof is involved, the interest is paid to it. The depositary, however, usually receives this money and at the direction of the committee, pays it over to the holders of the certificates of deposit.

When the interest is not paid by the receiver under order of the court, on the deposited bonds, the committee may advance to the holders of the certificates the amount of such interest as a loan from it to them. To raise the money necessary for such advances, the committee may pledge such bonds and their unmatured coupons. When such a loan is made it is noted on the certificate of deposit held by the party receiving the money. Should a party withdraw from the agreement, he shall not be entitled to receive the bonds represented by his certificate of deposit until, among other things, he has returned such interest so advanced to him with interest thereon.

When the reorganization has been carried out the certificates are surrendered to the depositary and the new securities are delivered in their place.

Synopsis of the plan for reorganization.

The plan contains the details of the arrangement by which the property of the insolvent road is to be acquired at the foreclosure sale or otherwise, the terms under which the corporation shall be reorganized or a new corporation formed, how the property acquired shall be transferred and held by such new company, what stock and securities the new corporation shall issue, the rights and standing that the bondholders, the other creditors, and the stockholders, shall have in the reorganized corporation or the

new corporation, and what stock or securities shall be allotted to each to represent his interest in the reorganized or the new corporation, the assessments that shall be levied against stockholders and others, and such other matters are provided for as in each particular case the exigencies require.

The plan has such financing in view as will start the new corporation in business on a promising basis. The stockholders of the old corporation, it usually provides, may become such of the new corporation upon paying a specified sum for each share of stock issued to them. The plan may contemplate also an issue of bonds by the new corporation to raise money, among other purposes, to pay off receivers' certificates or other charges or liens existing or continuing against the property with which it shall do business.

Where the property against which mortgages are liens is taken over by the new corporation subject to such mortgages, holders of the bonds of the old company secured by such mortgages may deem it advisable to assist the new corporation, and, accordingly, may surrender their bonds and in exchange take bonds of the new corporation at a lower rate of interest, extending the time of payment, and sometimes for a less amount, releasing the balance. Sometimes the bondholders may think it good policy to waive their lien against such property, under their mortgage, in favor of a new issue that the new cor-

poration puts out or exchange their bonds for those of such new issue.

In these and other ways that the plan may contain, the effort is made to start the new corporation on a financial basis as satisfactory as the conditions warrant.

The plan may contain provisions for assessments which the committee shall have authority to levy in its discretion against the parties participating in the reorganization; a maximum amount may be fixed, however, beyond which the committee shall not go in assessing each bond or share of stock.

Filing the plan; giving notice thereof; reasonable opportunity to examine it; proposed changes; remedies when committee fails to file plan or give proper notice.

Sometimes the committee is given the authority, in its discretion, to adopt a plan and put the same into operation without submitting it to the parties to the agreement for their approval. Any plan adopted under such authority, in the absence of any fraud or abuse of power, is binding on all the parties to the agreement.

Usually, however, it is the duty of the committee to submit the plan, or any material changes in it, to all the parties to the agreement for their approval or disapproval.

When it is the duty of the committee to submit

the plan to the parties to the agreement for their approval or rejection, it must file its proposed plan with the depositary. Each party to the agreement is entitled to notice of the fact that the plan has been filed, so that he may examine it and acquaint himself with its terms. This matter of notice is usually provided for in the reorganization agreement. The usual provision is that the notice shall be published in newspapers of general circulation in specified cities that are recognized financial centers, and sometimes, in addition, that copies of the notice and the plan shall be mailed to each registered holder of the certificates of deposit, to his address as the same appears on the books of the depositary.

Should the committee propose making material or important changes in the plan, when it is its duty to submit the same to the parties to the agreement, it must file such changes with the depositary, and give notice thereof. The notice and manner of giving it are usually the same as in the case of the filing of the original plan just discussed.

Each party to the agreement is entitled to a reasonable opportunity to examine the proposed plan or the proposed changed plan.

Should the committee, when it is required to do so, fail to file the original plan, or the changed plan, the court will compel it. And if the original plan or the changed plan be filed under such conditions, as to time and circumstances, that the parties do not

have a reasonable opportunity to examine it, the court will relieve them of any default they may be guilty of due to this delinquency of the committee. And the court will see that the parties are accorded a fair chance to become acquainted with the terms of these documents, so that they may determine the course they shall pursue with respect to them.

How plan is formulated and submitted; when contained in agreement; discretion of committee to adopt plan; submitting plan for assent or dissent; expressing assent or dissent; amount necessary to approve or reject; written assents or dissents; majority and minority rights on approval or rejection of plan.

As a general rule, the committee formulates the plan or adopts one formulated by others, and submits it to the parties to the agreement for their approval or disapproval.

Sometimes, though rarely, the plan is contained in the agreement itself. When the plan is contained in the agreement, it was assented to by all when they became parties to the agreement. It need not be submitted to them again for their approval.

The agreement sometimes leaves it to the committee to put into operation such plan as it may, in its discretion, believe best. When the committee is given this discretionary power its plan is not submitted to the parties, as they are bound, under the

circumstances, by whatever plan the committee, in good faith and without any abuse of its power, may propose.

But, no matter how uncontrolled a discretion may be given the committee, its acts are always subject to the supervision of the court. Be its powers ever so broad, the committee, at all times, must act in good faith toward the parties it represents, and must not abuse or misuse the powers conferred on it.

However, the agreement may declare, and it usually does, that the committee shall submit its proposed plan to the parties for their consideration. It then provides for the manner in which the parties shall express their assents to or dissents from such plan.

The manner in which assents or dissents shall be expressed is stated in the agreement. Some agreements say that the parties to the agreement wishing to object to the proposed plan shall file their *dissents* with the depositary. When dissents representing a certain proportion in amount of the deposited securities have been thus filed, the plan shall be considered rejected and, thereupon, another submitted. Should the requisite number of dissents not be filed, the plan is considered approved and binding on all.

Some agreements provide for the withdrawal of those parties who do not wish to be bound by the proposed plan. These provisions are to the effect that

those who do not approve of the proposed plan and desire to withdraw shall surrender their certificates of deposit to the depositary, and, upon paying the amounts charged against such securities, shall receive in return securities represented by such certificate of deposit and thereupon shall be deemed to have dissented from the plan and withdrawn from the agreement and are relieved from all liability in any further proceedings under it.

On the other hand, the agreement may provide for the filing of *assents* with the depositary; and that those who do not file their assents shall be deemed to have objected to the plan. When the requisite amount of assents have been filed the plan is deemed approved; should the requisite amount of assents not be filed, the plan fails to be approved and another is submitted.

What shall constitute the requisite amount or proportion of assents or dissents, to approve or reject a plan, as the case may be, and the time within which they shall be filed, are fixed usually in the agreement, though it is sometimes left to the committee to determine.

The rejection of the plan because the requisite amount or proportion of assents have not been filed, or because the specified amount or proportion of dissents have been filed, results in another plan being submitted. This course is more favored, in some cases, than that which permits the dissenting parties

to withdraw their securities; for should large holdings be withdrawn, the resources of the committee may be reduced so as to materially interfere with, if not prevent, the purchase of the property and the carrying out of the reorganization.

The committee gives notice by advertisements in the newspapers, or in such other manner as it may believe advisable, whether the plan is adopted or rejected.

If it be necessary that written assents or dissents be filed they must be executed by those appearing as the registered owners of the certificates of deposit at the time the registration or transfer books of the depositary were closed for that purpose. Or the paper may be executed in the name of such registered owner by some one duly authorized.

It is sometimes provided in the agreement that if the plan or the changed plan, as the case may be, be approved by a certain majority in amount of the certificates of deposit, it shall be binding on all the parties to the agreement, notwithstanding that the minority objects. In the absence of such a provision the consent of the majority, no matter how large, cannot affect the rights of the minority and force upon the latter a plan which they do not approve. However, to avoid forcing the minority into a plan it does not approve and to allow it to withdraw under such circumstances, the provision is frequently inserted in reorganization agreements by which those

who object to the plan or the changed plan, as the case may be, may withdraw from the agreement and no longer be bound by it.

When the plan of the majority is carried out under such a provision in the agreement as just mentioned, against the objection of a minority, the court will see that there is no pretense of any fraud or oppression in what the majority propose doing and that the interests of the minority are protected.

When plan takes effect; abandoning plan after adoption.

Sometimes the agreement mentions when the plan shall become operative and take effect, but, as a general rule, this is left to the committee, in its discretion, to decide.

When the plan is made operative the committee gives notice of this fact by advertisement, or in such other manner as it may believe best.

The committee decides also when it shall proceed to carry out the terms of the plan after it has become operative by approval of the parties or by the will of the committee. See *Discretion of committee to adopt plan; submitting plan for assent or dissent.* Page 360.

Under the usual form of reorganization agreement, the powers of the committee with relation to carrying out the plan are very broad and quite generally include the authority to abandon it, notwith-

standing that it has been declared in operation. Should the committee abandon the plan, the parties to the agreement who have deposited are entitled to a return of the securities represented by their certificates of deposit, and thereafter they occupy the same position as they did before they became parties to the agreement. As a condition of the return of the securities, the certificate of deposit representing them must be surrendered and the proportionate share of the expenses of the reorganization, chargeable against them, must be paid.

Changes in the agreement or the plan; power of committee to make changes; uncontrolled power; limited to certain matters; material changes; submitting changes to parties; unauthorized changes; ratification or rejection; ratification by majority; changes by majority against objection of minority; provisions for majority control.

Each party to the agreement is entitled to say whether or not he shall be bound by any changes in it or in the plan, unless he has conferred on the committee or on the majority of the holders of the deposited securities the power to speak for him in this regard and bind him by their acts.

The committee is usually authorized by the agreement to supply such minor omissions and remedy such immaterial defects in the agreement or in the

plan as in its absolute and uncontrolled discretion it may think proper and advisable.

The power to make changes in the agreement or in the plan is delegated usually to the committee by the agreement. It is then a matter for inquiry as to the extent of the authority the agreement confers. The agreement may give the committee an uncontrolled and absolute discretion to make changes; or its action may be limited to changes with relation to certain specified matters; or it may be limited to changes with regard to all matters which are immaterial or are not substantial; or its powers may be regulated otherwise.

Usually agreements provide that substantial or material changes shall be submitted by the committee to the parties for their approval or rejection. This must then be done.

Some agreements empower the committee to decide whether or not the change is material or substantial, and declare that its judgment or decision in this regard shall be final and conclusive and all the parties to the agreement shall be bound thereby. Such an authority is so broad and inclusive that the committee under it, in the absence of bad faith, may act almost without restriction.

When the committee is required to submit proposed changes in the plan or in the agreement to the parties, it files the proposed changes with the depositary, and the same course is then pursued to

either reject or accept the changes as in the case of the original plan. See *Submitting plan for assent or dissent*. Page 360.

Sometimes those not approving the changes in the plan or in the agreement are permitted by the agreement to withdraw; then those continuing carry out the reorganization. But as a large majority in amount of the holdings may be withdrawn and thus weaken and perhaps render ineffective the resources at the command of the committee, the more prudent method is often favored by which, should the proposed plan not be approved by the necessary amount, or should it be rejected by the filed dissents, that it shall be considered abandoned and another submitted. Though under the arrangement whereby the parties to the agreement may withdraw their holdings should they object to the plan or the changes in the plan or in the agreement, it is sometimes provided that the committee may withdraw any proposed plan or changes in the plan or in the agreement when it sees that too many of the parties are withdrawing; upon the committee thus retracting such proposed changes, the right of all remaining parties to withdraw immediately ceases.

A majority has no power to bind a minority by a consent to the plan or to changes in the plan or in the agreement; nor has it the power to bind the minority by its ratification, acceptance, or confirmance of any unauthorized plan or unauthorized changes in the

plan or in the agreement, unless the mortgage or the reorganization agreement specifically gives the majority this right to bind the minority in these particulars.

The mortgage or the agreement may provide that a majority, or a majority of a specified amount, may consent to the plan submitted, or to the changes in the plan or in the agreement, and that their consent in these particulars shall be binding on all. The only obligation on the majority then is that it must act in good faith and without any fraud or oppression.

When a change is made in the agreement or in the plan by reason of the consent of the majority against the objections of the minority, such changes will be strictly construed and the court will regard the language employed as having only that meaning that is plainly expressed by its terms and will not extend it to cover by inference anything else. Should there be doubt as to whether or not the language of the agreement confers this power on the majority, the court, under these circumstances, when there is a reasonable opportunity to do so, will decide that it does not.

Powers of the committee; defined by agreement; discretionary powers; positive instructions.

The committee as a rule has such powers only as the agreement or the plan gives it. Reorganization

agreements quite generally give the committee rather broad and all-inclusive powers. They usually authorize it to execute all writings and do all acts that may be found necessary in the course of the reorganization proceedings to carry out the terms of the agreement or the plan. In fact some reorganization agreements go to the extent of conferring on the committee any power or authority that it, in its uncontrolled discretion, may think necessary to carry out the agreement, even though such power or authority be not expressed or contemplated in the agreement.

When the committee is not given the power to act according to its best judgment and discretion, it often finds in the course of its work that it is hampered in meeting the many details presenting themselves from time to time and requiring its attention. It would be impracticable to seek the advice of the parties to the agreement and to ask their permission to act in such minor matters. The men who are selected to act as a reorganization committee usually are men of standing and skilled in that kind of work; the law, independent of any provision in the agreement to that effect, confers on the committee a *reasonable* discretion to act according to its best judgment in minor matters and details. However, agreements for reorganization usually provide for the power of the committee in minor matters and details, and, quite generally, go further than the law in this regard, and vest in the committee an absolute

and uncontrolled discretion in carrying out all the terms of the agreement.

However, no matter how broad and unlimited a discretion may be given the committee, it has no power to disregard any positive instructions that the agreements may contain.

Committee may employ representatives.

The committee has the authority to employ legal counsel, agents, or other representatives, necessary to carry out the reorganization. But it may not delegate to others the exercise of that executive control and management to which the parties to the agreement are entitled to believe the committee will give their personal attention, unless the agreement permits it. Sometimes the agreement authorizes the committee to appoint managers, sub-committees, or other representatives, and to confer on them the same powers that it, the original committee, had should it deem it necessary or expedient; and it is usually further provided that the compensation and disbursements of such managers or sub-committees shall be charged against the property and the deposited securities, as an expense of the reorganization.

Committee may construe, remedy, change, prepare, adopt, declare operative, abandon plan.

Agreements for reorganization often authorize the committee to place its own construction upon the

terms of the agreement and to say just what the language employed shall mean; and, further, that the construction the committee so places upon the terms of the agreement shall be final and binding on all the parties.

Reorganization agreements also quite generally confer the power on the committee to supply any omissions or remedy any defects in the agreement or the plan that in its judgment it believes necessary to carry out the purposes of such agreement or plan. In thus construing the terms of the agreement, and in supplying omissions, and in curing defects, the committee must act in good faith.

The committee may be empowered by the agreement to make changes in the plan or in the agreement; or the agreement may declare such changes may be made only on the approval of the parties themselves.

The agreement usually grants to the committee the authority to prepare a plan for reorganization or to approve and to adopt a plan though not prepared by it. That it shall then submit such plan, whether prepared or approved or adopted by it, to the parties for their approval or disapproval; and, sometimes, the agreement lets it to the committee to decide when sufficient assents to the plan have been filed to approve it, and when the necessary dissents have been filed to disapprove it. The agreement may also give the committee the authority to limit the period or

extend the time within which the parties to the agreement shall assent to or dissent from the plan submitted by it. Some agreements provide that all the parties to it shall be bound by any plan that the committee shall submit; in such case the only limitation on the committee is that it shall act in good faith.

It is left to the committee usually to declare when the plan shall become operative and go into effect, and when it shall proceed to carry out its terms.

The committee is sometimes given the power to declare the plan abandoned even after it has declared it operative.

Allowing parties to join in the reorganization; co-operation with other committees.

Agreements sometimes give the authority to the committee to permit the stockholders and different aggregations of creditors of the insolvent road to join in the reorganization proceedings, should it deem it advisable, and to fix the terms upon which they shall become parties.

As a general rule, reorganization agreements give the committee the power to limit the period within which the bonds or other securities may be deposited, together with the further power to extend such time and to impose a penalty as a condition of receiving them after the original period has expired.

When the reorganization may be conducted advisedly in conjunction with another, proposed by

other persons interested in other parts of the insolvent road, or with the holders of other securities or obligations of the company interested in the same part, the committee is usually empowered by the agreement to participate in and cooperate with such other proceedings.

Power of the committee over deposited bonds.

With relation to the deposited securities, agreements for reorganization customarily confer on the committee the authority to collect and receive all sums due on them, and to act with relation to them as if it were the owner, subject, however, to the terms of the agreement. The committee may attend meetings of the holders of the bonds under that issue and may vote on such deposited bonds, stocks and other securities.

The agreement invariably authorizes the committee to use the deposited bonds in whole or in part payment of the purchase price of the property of the road to be bought for the purposes of the reorganization, or to pledge them to procure the funds to pay such purchase price.

It is also usual that the committee shall have the power to pay off or to satisfy claims entitled to prior payment and secured by prior liens against the property of the insolvent road that it has purchased at the foreclosure sale or otherwise acquired, if in its opinion it will protect the deposited bonds and be

to the best interests of the parties to the reorganization.

Pursuing the remedies of the bondholders.

All litigation necessary to protect the rights and remedies of the holders of the deposited securities, which such holders might have conducted but for the reorganization, may be carried on by the committee. The committee, generally speaking, stands as the owner of the deposited securities. The committee, under the usual form of agreement, has the authority to request the trustee to pursue all remedies and to institute or to defend any legal proceedings or actions necessary to enforce payment of the deposited bonds; should it believe it advisable for the protection of the parties to the agreement.

Committee may acquire property; its powers with respect to same.

Under the usual form of agreement the committee may take such steps as it believes necessary to purchase or to acquire the property of the insolvent road for the purpose of carrying out the objects of the reorganization or the plan, and may deal with the property so acquired as if it were the actual owner; but the agreement usually provides that the committee shall not be bound to make such purchase merely because it is authorized to do so.

The agreement also usually empowers the commit-

tee to sell any or all property acquired, in such manner and at such prices as in its discretion it thinks best, if it believe it advisable in the course of the reorganization.

The committee is also quite generally authorized to pay off any bonds or notes, or other obligations of the insolvent company, that are secured by property or by collateral, the acquisition of which property or collateral the committee may deem advantageous or advisable for the purposes of the reorganization. And it may use the deposited securities to make such payments or may pledge them to raise the money necessary therefor.

Expenditures and debts by committee; expenses; may consent to receiver's certificates.

Reorganization agreements also quite generally confer on the committee the power to make necessary expenditures, to borrow money, and to incur such debts as in its discretion it thinks necessary to carry out the reorganization or to protect the interests of the parties to the agreement, and to pledge the deposited bonds and all property it may have acquired to secure the payment of the debts so incurred, including its own expenses and compensation. This includes also the compensation and disbursements of the managers, subcommittees and other representatives, that it may have properly employed.

Though the authority to do so may not be granted

specifically, yet under some of the powers granted to the committee the power may be inferred and, accordingly, it may join in and assent to an application by the receiver for the issuance of receiver's certificates, which under the order of the court may be given a priority in payment over the bonds and other securities deposited under the reorganization agreement.

Personnel of the committee.

The agreement usually empowers the committee to fill any vacancies in its membership; and sometimes to add to its numbers such additional members as it may deem necessary. Sometimes the committee reserves to itself the right to withdraw at any time upon giving due notice to the depositing security holders. Under these circumstances the depositing security holders are entitled to the return of securities represented by their certificates of deposit, upon paying their proportionate shares of the expenses incurred and any sum that may have been advanced to them with interest thereon.

Individual interest of the committee.

Reorganization agreements quite generally provide that any member of the committee and any firm or corporation of which the committee or any of its number may be a member or officer, may become pecuniarily interested in the property or in the securi-

ties that may be involved in the agreement or the plan or be acquired under them.

Duties of the committee; good faith; will of majority; accounting; time within which to complete reorganization; five years' provision.

Generally speaking, the committee is charged with the duty of carrying out the terms of the agreement and the plan. It should be remembered, however, that under the usual form of agreement, the committee may withdraw at any time and may abandon the agreement and the plan, though it has declared the latter operative and in effect. But in carrying out any work that it has undertaken it is accountable for its actions.

The committee must act at all times in good faith.

The duties which the committee assumes it owes to each party to the agreement. It acts for all the parties and not for a majority, no matter how large, unless the agreement provides that the will of the majority shall prevail with relation to the matter in question.

The committee, therefore, has no power to disregard any positive instructions contained in the agreement at the request of the majority. Each party may insist that the committee fully perform its duties according to the terms of the agreement; and should he suffer a pecuniary loss by reason of any wrongdoing by the committee, he is entitled to sue

and recover damages from the committee personally, unless the act be one for which the agreement or the law declares the committee shall not be liable.

When the committee has carried out the reorganization, or if the proceedings have been terminated sooner, it must file with the depositary an accounting of its receipts and disbursements. The agreement usually provides that upon filing this accounting, the committee shall be discharged from further liability with respect to the agreement or the plan. See *Accounting and discharge.* Page 382.

The manner of and the time for the performance of many of the duties of the committee are left largely, as was seen, to its discretion. The time within which it shall submit a plan is left also to its discretion.

The period within which it shall carry out the terms of the agreement and the plan, and otherwise perfect the reorganization, and deliver to the parties the securities of the new corporation or return the deposited securities, is left usually to its discretion; though most agreements fix such period at five years in order to comply with the rules of the Committee on Stock List of the New York Stock Exchange. It is usually contemplated by the parties that the reorganization shall be completed within a shorter period.

While the committee may not be limited as to the time within which it shall complete the reorganiza-

tion, should it neglect its duties and not proceed for an unreasonable time, the court may declare the agreement abandoned and relieve the parties from any further obligations under it.

Personal liability of the committee; money damages; injunction; compelling performance of duties; declaring acts void; error of judgment; limitation of liability; who affected by limitation; liability to third persons; liability for acts of co-members; accounting and discharge.

The committee is liable, ordinarily, to any party to the agreement who suffers a pecuniary loss by reason of its wrongdoing in carrying out the reorganization, or with relation to any of the matters contained in the agreement. The liability of the committee in favor of the parties to the agreement is not charged against the property in its custody, as this liability is a personal one.

The law awards any party to the agreement who has suffered a financial loss, by reason of the wrongful acts of the committee, damages in money to compensate him for such loss; and the court may stop, by injunction, any wrongful act the committee threatens to do. Should the committee have carried out the wrongful act, the court may, under proper circumstances, set it aside and declare it void and of no effect.

As was seen, the committee is often vested, in

many matters, with discretion and justified in such cases in acting according to its best judgment. An error of judgment where there is no bad faith will not subject the committee to any liability even though it may have caused damage.

Reorganization agreements, however, usually grant the committee a certain protection and immunity from liability by declaring that neither the committee nor any of its members shall be liable to any of the parties to the agreement for any act or omission to act of any of its representatives, provided it has selected these representatives in good faith. Its only duty with respect to its representatives is that it shall use reasonable care in selecting them; if the committee has done that, according to these provisions, it is not liable for any wrong act of its representatives. The agreements also, as an invariable rule, provide that the committee shall not be liable for anything other than its own wilful wrongdoing or gross negligence. It seems, too, from the trend of decisions that the courts hold the members of a reorganization committee personally liable only for its own gross negligence or wilful wrong, even where the agreements do not make such a provision.

The committee, as a rule, by these provisions in the agreement, seeks to avoid personal liability as it feels that it is acting for the protection and benefit of all the parties to the agreement; hence these pro-

visions that exempt it from personal liability in all cases except where it has itself done wrong wilfully or is grossly careless.

Notwithstanding any provisions in the agreement by which the parties to it (the committee, the depositary, and the depositors of the securities) may agree to limit the liability of the committee as to themselves, it remains liable under the ordinary rules of law to all third persons to whom it may cause any damage; for such third persons are not bound by agreements to which they are not parties. These limitations of the liability of the committee can affect only those who are parties to it and relieves the committee only in its relations with such parties.

Should the committee in the course of carrying out the reorganization or the plan become liable to third persons on an official contract, or by reason of some official act or negligence in carrying out an official act, its liability is in its representative capacity as a committee. The damages in such a case are regarded as an expense of the reorganization and are paid out of the property the committee has acquired under the reorganization agreement, including the deposited securities.

Ordinarily, in cases of co-trusteeship—which relation the members of the reorganization committee bear to each other—one trustee is not liable for the acts of the other, except in those cases where with

knowledge of the facts he stands by without protest and permits his associate to do wrong. This seeming acquiescence in the wrong act and failure to object renders him as legally liable as if he had actually participated. And even though he be ignorant of the acts of his wrong-doing associate, if the circumstances be such that he should have known what was going on, he is negligent in not knowing, and he is charged with the same knowledge and liability as if he were actually cognizant of the act complained of and permitted it to be done without protest. However, most agreements provide that one member of the committee shall not be liable for the acts of any other member.

It is the duty of the committee to render an accounting of its acts while in office. Reorganization agreements usually provide that when the committee has filed such an accounting with the depositary, or has returned to the parties to the agreement the securities they have deposited under it and represented by their certificates of deposit, or has delivered to them the securities of the new corporation to which they are entitled, then all duties and liabilities of the committee to the parties to the agreement shall cease. But any of the parties are entitled to have the acts of the committee and its accounting reviewed by the court should there exist legal ground therefor, such as fraud, or other evidence of bad faith.

Purchase of property of insolvent road by bondholders or committee; using bonds in payment; payment of costs in cash; when purchased by others; committee using own money; failure to complete purchase; deficiency on resale.

Experience has shown that a fair price can be obtained and a sacrifice avoided in the sale of the property of the insolvent road at foreclosure only by the bondholders under the foreclosed mortgage using their bonds in bulk to make the purchase. Accordingly, the bondholders under the foreclosed mortgage, or the reorganization committee representing them, are permitted to pay their bid in whole or in part with their bonds and the balance, if any, in cash.

The bondholders under the foreclosed mortgage are thus permitted to use their bonds in the purchase because the proceeds of the foreclosure eventually will come to them in money.

Each bond is accepted for such sum as it is entitled to receive as its proportionate share of the proceeds of the sale. Each bond is accepted for such an amount as it would receive upon a final distribution.

However, this payment of the bid by the bondholders, or their committee, with bonds secured by the foreclosed mortgage, is usually subject to the condition that the costs and charges of the litigation and of the trusteeship and the expenses of the sale shall be paid in cash.

The court in ordering the foreclosure sale may, in its decree, declare that should the purchaser not be a bondholder under the foreclosed mortgage, he shall pay at once, in cash, part of his bid as a deposit or earnest money.

Should some of the parties to the agreement not pay their proportionate shares of the assessments or charges levied by the committee in order to make the purchase, and the committee, with money that it has furnished itself, completes the purchase, the court will hold that it has not acquired the property as individuals but that such committee holds it in trust for and as the representatives of those who have complied with the terms of the agreement and have contributed their *pro rata* shares. For such sums as the committee has advanced, it is entitled to be reimbursed from those who have accepted its purchase, and the property purchased is charged with the payment of such moneys so advanced before the bondholders receive anything therefrom.

Should the bondholders or the committee, as the case may be, conclude that the price bid at the foreclosure sale was too high and that it would not be advisable to take over the property and operate it at that figure, the property is sold again, under the order of the court, and if on the resale it should bring less, then the parties to the agreement may be held liable for the deficiency. They are not entitled ordinarily to the return of the deposit made.

Parties to the agreement are bound by all proper acts of the committee; rule when committee acts wrongfully; ratification of unauthorized acts; remedies for wrongful acts.

The parties to the agreement are bound by all acts of the committee when acting within the scope of its authority in carrying out the terms of the agreement or the plan. They are not bound, however, when the committee acts fraudulently nor when it acts in violation or in excess of its authority.

Should the parties to the agreement ratify, confirm, adopt, or accept, by word or conduct, any unauthorized action of the committee, they are bound by it with the same effect as if the act had been authorized before it was done. To reject an unauthorized act of the committee, the party must proceed to do so without delay after becoming acquainted with the facts. A failure to act promptly under those circumstances may be construed as an acquiescence in the act complained of, and an acceptance of it. Silence for an unreasonable period after learning of the unauthorized action may be construed as a consent to it.

Should the committee threaten to carry into effect an act that is tainted with fraud or which is in violation or in excess of its authority, the court may stop it by injunction; or if the act has already been carried out, the court may declare it void and set it aside and order such restitution and attempt to place the parties in or as near to their original positions as they

occupied before the transaction was consummated, as the circumstances of the case permit.

Parties to the agreement bound by its terms; must deposit bonds; must pay share of expenses, etc.; when such expenses are not paid; parties avoiding liability under agreement; abandonment.

Each party to the agreement is usually bound by all its terms and is entitled to all its benefits. Accordingly, when so bound, he must comply with all its requirements as to the deposit or delivery of his bonds (if a bondholder) and shall, when requested by the committee, execute such necessary transfers, powers of attorney, or other documents as the committee reasonably may require to enable it to use the deposited bonds according to the terms of the reorganization agreement or the plan.

Each party to the agreement must pay his share of the expenses of the reorganization, which includes the compensation of the committee and such other assessments as the agreement or the plan shall specify.

Should the parties to the agreement fail to pay their proportion of the expenses of the reorganization, the committee is entitled to withdraw and refuse to proceed. Should the property of the insolvent road have already been purchased, the court will order it sold again and any deficiency on the resale will be charged against the parties to the agreement proportionately.

As the agreement for reorganization is a contract, each party to it is bound by all its terms and must do all that it declares he shall. He can only avoid liability by showing that he was induced illegally to become a party to it, as by fraud; or he may be relieved from further liability by withdrawing from the agreement when the agreement itself permits this.

Should the committee abandon the reorganization, it relieves the other parties to it from further liability under it. They then stand upon their original rights and each is entitled to his proportionate share of the proceeds of the sale of the property covered by his mortgage.

The abandonment of the reorganization by the committee or the withdrawal from it by the parties relieves the latter from further liability from that time on; but as to obligations already incurred before the committee abandoned the reorganization or before his withdrawal, each party continues liable.

Should the committee abandon the reorganization, the court may, under some circumstances, declare that it has lost its right to compensation.

Withdrawing from the agreement; surrender of certificates; payment of expenses and charges; return of securities; limitation of time.

It was just seen that each party is usually bound by the terms of the agreement and usually may not avoid his responsibility under it and withdraw, unless

the agreement specifically provides that he may do so. In making a provision of this kind the agreement, at the same time, regulates such withdrawal. Agreements for reorganization usually do provide for circumstances and conditions that may arise when it would not be fair to ask the parties to proceed further should they not be in harmony with the course being then pursued; and therefore, they contain provisions under which such parties are given an opportunity to withdraw. This is usually when the plan is submitted and not approved by them, or the agreement or the plan is changed against the objections of such parties. If the committee is not bound, the depositors are not, and may withdraw without permission.

The privilege to withdraw from the reorganization is granted only upon the condition that the party withdrawing shall surrender his certificate of deposit to the depositary, endorsed in blank, and with such other assignments, transfers, or powers, as may be required, and thereupon he shall receive in return the securities represented by his certificate; and also that he shall pay such sums as may be charged against the securities represented by that certificate. These charges are usually the amount, with interest, of any interest that may have been advanced by the committee on the securities to be withdrawn and such sums as the committee may fix as a fair *pro rata* contribution toward the expenses of the reorganization and its own compensation. The committee is entitled to

require as a further condition of withdrawal that the party withdrawing shall pay its proportionate share of any moneys the committee may have advanced in the course of the reorganization for purposes other than its own expenses and compensation.

The committee may also require that the withdrawing party shall pay his proportionate share of such sums as the committee may require to be held by the depositary to indemnify it (the committee) against any obligation it may have incurred in the course of the reorganization. The amount of this sum is fixed by the committee; but it is usually provided that it shall not exceed one per centum of the face amount of each bond, or note, or other obligation.

The withdrawing party, when paying his proportionate share of the moneys paid out by the committee or as indemnity against obligations incurred by it, is given a certificate or other written evidence of his share or interest in those moneys. This certificate is in such form as the committee shall prescribe. Should it eventually transpire that the amount so withheld is not necessary or more than necessary the party depositing or advancing it is entitled to its return or to his proportionate share of the excess.

Upon paying all charges against his securities and surrendering his certificate of deposit, securities represented by such certificate of deposit are returned to the withdrawing party and he is regarded as having

withdrawn from the agreement and the reorganization proceedings, and is no longer bound by them, nor entitled to any of their benefits.

The time within which a party may withdraw from an agreement for reorganization is usually limited in the agreement itself. Should he not withdraw within the specified time, he is presumed to have consented to the plan or to the changes in the agreement or the plan, and is bound by their terms as so changed. He has then lost the right to withdraw.

It is sometimes provided that the committee may withdraw a proposed plan, or changes to a plan or agreement, when it sees that too many of the parties are objecting and withdrawing. When the committee withdraws the plan or the changes in the plan or in the agreement, the rights of the parties to the agreement to withdraw from it immediately cease. Those who have not availed themselves of the privilege have lost it unless it be given again with relation to some other plan or changes.

Termination of the agreement; by completing reorganization; committee may terminate; court may declare agreement abandoned; rights of parties when terminated by court or committee.

When the reorganization has been carried out the agreement is terminated because it has been fully performed and there is nothing further to do.

However, at any intermediate stage of the reorganization, the committee is quite generally empowered by the agreement to terminate it whenever it shall consider such a course best or advisable. In the absence of such a power in the committee, the agreement must continue in force until it is performed and the reorganization carried out; or until it is declared abandoned by the court; or all the parties by mutual consent dissolve the agreement and adjust matters to their mutual satisfaction among themselves.

Should the committee abandon its task, it relieves the other parties to the agreement from performing their obligations, and they may ask the court to declare the agreement abandoned and terminated.

Should the committee, under its power to do so, declare the agreement terminated, or should the court so declare it, the parties are relieved from further obligation under it; and they should then be put in the positions they were in before the reorganization was commenced, so far as the condition of affairs and the situation of the parties and the property permits. Accordingly, parties who have deposited their securities may surrender their certificates of deposit to the depositary and receive in return the securities represented by these certificates, upon complying with the terms imposed by the court or the committee, as the case may be. These terms usually are that the person withdrawing his securities shall return the

amount (with interest) that may have been advanced by the committee as interest upon the securities he withdraws; and that he shall pay his proportionate share of the expenses of the committee; and the committee may also require that the party pay at that time his proportionate share of such sums as the committee may have expended in the course of the reorganization, for purposes other than its expenses and compensation, such as discharging prior liens or other payments of like nature necessary or deemed advisable to protect the securities deposited; and too, the withdrawing party shall pay such sums as the committee shall require to be held by the depositary to indemnify it (the committee) against any obligation it may have incurred under the agreement.

Should the committee have abandoned the agreement unreasonably, or should it have acted wilfully neglectful, the court may declare that it has forfeited its right to compensation, should the situation justify such a decision.

Upon making payments of sums other than the return of interest and the expenses and compensation of the committee, the party receives a certificate or other writing or evidence of such moneys so deposited and advanced. Should the amount so held be eventually found not to be necessary or to be more than is necessary, the party so advancing or depositing this

sum is entitled to its return or to the return of his proportionate share of the excess, as the case may be.

Expenses of reorganization; charged against deposited securities; payment as condition of right to receive securities of new corporation.

The parties to the agreement in whose behalf the committee acts must defray the expenses of the reorganization. Such expenses include the compensation of the committee, proper fees for legal counsel, and other necessary outlays incurred in the course of carrying out their duties; including the compensation and disbursements of such managers, sub-committees, or other representatives that may have been properly employed or appointed. Any loss the committee or depositary may suffer in carrying out the reorganization are properly charged as expenses, where such loss was not caused by bad faith.

It is proper that the agreement should provide the manner for meeting these expenses. The parties to the agreement are bound by any provision for the expenses of the reorganization that the agreement or the plan may contain.

Should the agreement or the plan not provide for the payment of the expenses of the committee or of the reorganization, the law declares that each party participating shall pay his proportionate share. The

agreements or the plans usually make provisions to the same effect. See *Withdrawing from agreement; payment of expenses and charges.* Page 387.

The parties to the agreement are not entitled to their stock or other securities in the new corporation until they pay their proportionate share of the expenses of the reorganization and of such other moneys as are properly charged against them.

The new corporation; distinct legal body from old corporation; succeeding to franchises; name of new corporation; distinction between franchises to operate and franchise to exist as a corporation.

The new corporation, organized by the committee or the other purchasers at the foreclosure sale, is a separate and distinct legal body from the old insolvent road. Sometimes the reorganization is perfected without selling the property of the road at foreclosure, but by a general readjustment of its affairs; then the old corporation continues in operation and no new one is formed.

It has been held that the purchaser at the foreclosure sale of an insolvent railroad need not incorporate to operate the road. An individual may purchase the road and operate it as an individual, or may transfer it to others. The universal rule, however, is for the purchasers at the foreclosure sale to incorporate or to convey the property to a corporation

purposely formed to take over the property and operate the road.

Should the franchise to *operate* the road be included in the sale, as it quite generally is, the new corporation succeeds to all the powers and the rights that the old corporation had to operate the road. In succeeding to these franchises and powers and rights, the new corporation must assume the public obligations that the old corporation was charged with, and must maintain and keep the railroad in operation as a public highway for the transportation of persons and property and must carry out all regulations imposed by the State or governmental commissions with relation to the exercise of such franchises.

The new corporation may use the name of the old one, unless some law forbids it. However, the fact that the old corporation has been stripped of all its property by the foreclosure does not affect its continued existence as a corporation, unless the law of the State under which it was organized declares that the sale of its property at foreclosure shall dissolve the corporation. In the absence of such a statute, the old insolvent corporation continues and under its old name. While the old corporation may thus continue, it does so usually for the purposes only of winding up its affairs; it has no power any longer to operate the road, as its franchises to do so have been sold and are now held by the new corporation.

In those cases where the old corporation continues

and uses its name, the new corporation takes a name similar, substituting usually only the word "railway" for "railroad," or *vice versa.*

It may be opportune to call attention again to the distinction between the franchise to operate the railroad and the franchise to exist as a corporation. The old corporation continues in existence notwithstanding that all its property has been sold; it continues in existence until it has been legally dissolved by a proceeding instituted by the Attorney General acting for the sovereign power, the State, that created it.

The only power that can take away the life of a corporation is the power that gave it, i. e., the State. The right to be a corporation is acquired by compliance with certain formal requirements of statutes. The statutes of some States declare that the purchaser at the foreclosure sale need not comply with these formal requirements but shall become a corporation by reason of such purchase. The new corporation is created therefore either by formal incorporation or by reason of the purchase at the foreclosure sale.

If the franchise to operate is not included in the sale or does not pass to the purchaser for any reason, then the mere physical property only passes to the new corporation without the right to operate it as a railroad. Should the franchise to operate be included in the sale and pass to the new corporation,

it is owned and used by it the same as any other property. This new corporation then holds the property purchased at the foreclosure sale and with it also possesses the right to operate it as a railroad. It is then in a position to do business with this property so acquired, including the right to operate it, and, accordingly, proceeds to do business with such moneys as it may raise by one or more of the usual methods, i. e., by assessing the parties to the reorganization, by sale of its stock, bonds, notes, or other securities, and such credit as may be given it.

New corporation bound to issue stock, bonds, etc., according to agreement and plan; rights of parties to agreement to securities of new corporation; when such securities must issue; five years' rule; voting trust.

The new corporation is bound to issue to the parties to the agreement such stock, bonds or other securities as the agreement or the plan declares it shall. And the court will compel it to carry out completely the terms of the agreement or the plan in this regard. True, the new corporation never signed the agreement nor was it a party to it or to the plan that is sought to be enforced against it. It was not in existence at that time. But it came into existence as a result of the agreement and the plan: The law, accordingly, will read the agreement and the plan for reorganization into the charter of the

new corporation and compel it to enforce its provisions in this respect.

Should the reorganization have been carried out by the bondholders under the foreclosed mortgage alone, and the plan contemplates the distribution of the capital stock of the new corporation among them alone, each is entitled to receive his proportionate share of the stock issued. The stock of the new corporation when issued to them represents their ownership in the property that their bonds purchased.

Should the new corporation be capitalized for more than the amount for which the property was purchased at the foreclosure sale, with the object of raising money by the sale of the additional stock, then the share of the participating bondholder is confined to his proportionate share of the capital stock that represents the amount paid at the sale.

Bondholders do not always receive stock to represent their interests in the new corporation. Under some plans of reorganization they receive in exchange for their bonds, or their interest in the property purchased at the foreclosure, other bonds or notes of the new corporation. This is when stockholders of the old corporation join with the bondholders in the reorganization. Then the stockholders receive the stock of the new corporation upon paying in cash for it. The bondholders may also take stock in payment in whole or part of their bonds. Each reorganization depends upon the situa-

tion that confronts the committee, and each plan is made with the object of putting the new corporation upon a financial basis that will enable it to operate profitably, and at the same time satisfy, so far as the situation permits, all the persons and interests participating in the reorganization.

The agreement or the plan may designate the time within which the reorganization shall be completed and the stock or other securities of the new corporation shall be issued and distributed to the parties entitled to them. It is quite common for the agreement or the plan to limit the period to five years within which the reorganization shall be perfected and the securities of the new corporation distributed or the deposited securities returned. This is done to comply with the rule of the Committee on Stock List of the New York Stock Exchange.

The reorganization agreement may create a voting trust by which the committee or others are appointed voting trustees for a specified period; in some States limited to five years. By this accumulation of the voting rights into the hands of the voting trustees, on the bonds deposited and on the securities of the new corporation, the power to control the affairs of the reorganization and the policies of the new corporation is concentrated. While such voting trust is in force the bondholders have no vote on their deposited or new securities, but are bound by the vote of their voting trustees, when the latter act within the scope

of the powers conferred on them. Such voting trust, among other powers, may confer on such voting trustees the power to determine when the capital stock, bonds, or other securities of the new corporation shall be issued and distributed.

New corporation may take property free from all liens against it; may take subject to such liens; or some of them; other debts and contracts of the old corporation.

Whether or not the new corporation shall take the property of the insolvent road purchased at the foreclosure sale, or otherwise acquired, free from the mortgages or other liens against it having priority over the mortgage that was foreclosed, depends upon the order of the court ordering the property sold.

This decree, or order of the court, may direct that the property shall be sold subject to all mortgages or other liens having priority over the foreclosed mortgage. In such case the new corporation that purchases this property must pay these prior mortgages or other liens, so far as such property against which they are charged will do so. It has no liability for these payments beyond the value of the property against which they are charged. However, should the new corporation expressly assume certain debts as part of the purchase price, it must pay such debts without regard to the value of the property it takes over. By thus assuming a debt as part of the pur-

chase price, the new corporation makes it its own obligation.

The decree of the court may order that the property be sold free from such prior mortgages or other liens and that they be charged against the proceeds of the sale. These respective liens in this way are transferred from the property to the proceeds. The new corporation then takes the property free and clear of such mortgages, other liens and claims. Of course the purchase price in each case is different. When sold subject to prior mortgages and other liens only the equity in the property is actually paid. When sold free and clear of such prior mortgages and other liens, then the full purchase price is actually sold. By equity is meant, in the instance under discussion, what is left after the amount of all the prior mortgages and other liens are deducted from the value of the property in question.

In the absence of any understanding to the contrary the purchaser at the foreclosure sale takes the property free from all interests or claims of the insolvent railroad company itself, its stockholders, its unsecured or general creditors, and also of its creditors who were secured by mortgage or other liens that attached to the property later in point of time than that of the foreclosed mortgage. As to all these the foreclosure cuts off their rights in the property. As to those whose mortgages or other liens have priority over the foreclosed mortgage, the foreclosure

does not affect their rights in any way. They are entitled to be paid in full out of the property against which they are charged or out of its proceeds, according to their respective ranks and priorities, before the bonds under the foreclosed mortgage receive anything. Therefore the decree of the court provides for them by either continuing their liens against the property in the hands of the purchaser or by selling the property free from their liens and transferring such liens against the proceeds of sale.

Contracts made by the old corporation are not binding on the new corporation and it is in no way affected by them. But should the reorganization be carried out so that no new corporation is formed but the old company is continued in a readjusted form, then the contracts that it previously made continue against it, as there is no change in its corporate existence.

However, should the new corporation adopt a contract made by the old corporation, or accept any benefits under it and thus adopt it, it becomes liable on it.

New corporation not liable for contracts or debts of the receiver; exceptions.

The new corporation takes the property and franchises purchased at the foreclosure sale free from all claims for the debts and contracts that the receiver

incurred, unless a statute or an order of the court charges such claims against such property.

Such statute or order of the court may make the debts of the receiver, or certain of them, a condition of the sale, by either selling the property free from them and charging them against the proceeds, or by directing that the property be sold subject to their lien, whereupon the purchaser takes the property charged with their payment so far as the property itself will do so, there being no liability beyond that. Or such statute or order of the court may declare that the purchaser shall assume the payment of these claims as part of the purchase price; and he then becomes personally liable for such debts so assumed, without regard to the value of the property.

Receiver's certificates are, as a rule, made a lien, superior to that of the foreclosed mortgage, against the property and franchise to be sold, The certificates are then paid in full out of the proceeds of the sale of the property before the holders of the bonds under the foreclosed mortgage receive anything. The court may order the property sold subject to the lien of the certificates, whereupon the purchaser becomes liable for their payment to the extent of the value of the property against which they are a lien. Or the property may be sold free and clear of the certificates, and their lien transferred to the proceeds of the sale. Sometimes the property is

sold and as part of the purchase price the new corporation undertakes to pay the receiver's certificates, thus making them its own obligation.

The new corporation is not liable for damages for claims for injuries to persons or to property, committed by the receiver or his employees in the operation of the road during the receivership.

The new corporation is not liable for any negligence in the operation of the road until it takes over and assumes control. Should the receiver continue to operate the road after the sale, at the request of the committee, and after title to the property has passed to the purchasing committee or to the corporation it represents, then such new corporation shall be liable for all claims for damages to persons or property during that period.

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